

COMMITTEE ON WAYS AND MEANS U.S. HOUSE OF REPRESENTATIVES

EAST ASIA: CHALLENGES FOR U.S. ECO- NOMIC AND SECURITY INTERESTS IN THE 1990'S

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COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
April 15, 1988, Washington, DC.

Mr. JOSEPH E. ROSS,
*Director, Congressional Research Service,
Library of Congress,
Washington, DC.*

DEAR MR. ROSS: As you know, the Congressional Research Service and the Woodrow Wilson Center are together organizing a workshop conference on East Asian challenges to U.S. economic and security interests in the 1990s. The workshop, which is planned for June 29, would be timely in light of recent attention to the region. The results of this workshop would also be helpful to ongoing oversight of the Congress.

To help facilitate this planned activity, the Committee on Ways and Means would be pleased to cosponsor the event and arrange for publishing the workshop proceedings. For further coordination, your staff should continue to contact Rufus Yerxa of the Committee staff.

With warm regards, I am
Sincerely yours,

DAN ROSTENKOWSKI,
Chairman.

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SUMMARY*

The countries of East Asia, led by Japan, have experienced rapid economic growth over the past several decades. By most criteria, East Asia has outperformed other regions of the world by a large margin. The region's enhanced economic power and wealth has been accompanied by growing political influence. As a result, it has become commonplace to say that the world is on the verge of a Pacific Century.

In order to better understand the present and future challenges to U.S. interests emanating from East Asia, the Congressional Research Service and the Woodrow Wilson International Center for Scholars, under the sponsorship of the House Ways and Means Committee, organized a day-long workshop entitled East Asia: Challenges for U.S. Economic and Security Interests in the 1990s. Nineteen experts from government, academia, and the private sector were brought together to examine three interrelated questions:

- (1) What are the most significant trends that are transforming East Asia?
- (2) What are the implications of current trends for long-term U.S. interests?
- (3) What policy options does the United States have for meeting the East Asian challenge?

In addition to the formal panelists, a number of East Asian experts from congressional staffs, executive branch agencies, and the private sector participated in the workshop. The day's discussion was far-ranging, touching on many of the economic, technological, and security challenges the United States will face in the 1990s. The discussion was also provocative, particularly as it related to Japan's future regional and global role. A summary of the main currents of the discussion follows.

EAST ASIAN TRENDS

1. *Economic dynamism.* East Asia, defined as Japan, China, the four newly industrializing countries (NICs) of Asia (Taiwan, South Korea, Hong Kong, and Singapore), the four major ASEAN countries (Malaysia, Thailand, Indonesia, and the Philippines), and Australia and New Zealand, is a growing center of world economic power. A variety of economic, financial, and technological indicators support the contention that the fulcrum of world business activity is increasingly shifting toward East Asia. Outward-oriented economic policies, close government-business relationships, an educated and highly motivated work force, and a willingness to sacri-

*Prepared by Raymond J. Ahearn, Specialist in Asian Affairs, Congressional Research Service.

fice current consumption in favor of high rates of investment have played a major role in encouraging rapid economic development.

2. *Resistance to forming a regional economic organization.* Japan and the United States dominate the trade and investment relationships of the region. They are the first or second largest trading partner of almost every country in the region. The economic ties among the other countries in the region are growing, but are still much weaker than the ties with the United States and Japan. Fear of being dominated by Japan and the United States, lack of common interests, and longstanding political divisions are important reasons why the countries of the region have resisted joining a formal regional organization focused on economic issues. Informal regional cooperation, with the Soviet Union keen on participating, however, appears to be increasing.

3. *New economic and political challenges.* During the 1980s, the enormous current account deficits experienced by the United States served as a great engine of growth for East Asia. As the U.S. current account deficit stabilizes and begins to fall in the years ahead, U.S. imports from Asia will expand very slowly and may even start to fall. For economic growth to continue in the next 5 to 10 years in the region, Japan's imports from the rest of Asia will have to rise very rapidly and the countries in the region will have to trade more with each other. Increased trade competition, in turn, could lead to more intra-regional political conflict. China remains the perennial "wild card" with the prospect of successful economic reform likely causing major adjustment difficulties for countries such as Thailand and Malaysia.

At the same time, all countries in the region will remain under pressure from the United States and the European Community to open their economies further to foreign trade and investment flows. The more advanced countries in the region, such as Japan, Korea, and Taiwan, will be under pressure to restructure their economies away from exporting. As democratization occurs in countries such as South Korea and Taiwan, the process of economic liberalization will be complicated.

4. *A more influential Japan.* The sharp increase in Japan's economic power over the past few years has boosted its position of economic leadership in Asia. Japan today is the dominant foreign assistance donor in the region, and it is assuming a dominant position in trade and investment. In particular, the doubling in the value of yen since 1985 has caused a large shift in Japanese investment to other parts of Asia, particularly to Thailand, Singapore, and Malaysia. As Japanese subsidiaries increasingly establish production facilities throughout Asia, it is likely that the Japanese will become more accepting of imports of manufactured goods from the rest of Asia. If Japan truly does open up to imports from the rest of Asia, and continues to back away from narrow commercial considerations in its approach to foreign aid, its image may improve substantially.

The reversal of economic roles—Japan's becoming the world's largest creditor country and the United States the world's largest debtor country—has not only contributed to a perception in East Asia that Japan is on the rise but also that the United States is on the decline. This perception is particularly acute among a younger

generation of Japanese, Koreans, and other Asians that tend to see the United States as being unable to get its own economic house in order. As the generation of Asian leaders that grew up before or during World War II is replaced by a generation that has no direct memories of the respective roles played by the United States and Japan in the war, Japan's influence and stature could also be enhanced.

5. *Security threats diminished by economic developments.* Throughout East Asia, there is evidence that the quest for market share and prosperity is driving foreign policy changes that on balance are diminishing the security threats to the region. The most dramatic changes have occurred in the Soviet Union and China where the authorities have launched priority economic reform programs. As a result, the Soviet Union now deemphasizes the military factor in its approach to Asia in favor of economic participation. While there is less consensus on China's expansionist tendencies, it has back pedalled from its ideological competition for influence in North Korea in deference to expanding (albeit indirectly) its trade and investment ties with South Korea. In addition, fear of being left out of markets arguably has driven Taiwan to reach more of a political accommodation with Mainland China. The main security threats to the region appear to come from the very poor communist states—North Korea and Vietnam—and from societies that have lagged behind in economic development—Indonesia, the Philippines and increasingly Burma.

IMPLICATIONS OF TRENDS FOR LONG TERM U.S. INTERESTS

1. *Adjusting to East Asian dynamism.* Despite the fact that East Asia is comprised of very diverse countries that do not coordinate their economic policies, the region has complementarities among its economies not found in any other region of the world. The growing intensity of mutually supportive relationships, particularly between Japan and the rest of Asia, arguably has created an economic challenge that the world has never seen before. The challenge of trying to adjust to the region's higher savings rates, more aggressive business and industrial strategies, and proportionately higher expenditures on research and development is immense. Nothing less than preserving the U.S. standard of living is at stake in meeting the challenge.

2. *Declining American influence.* A part of U.S. influence and power over the past 40 years has derived from the ability of the U.S. economy to absorb vast amounts of imports and to export a large amount of capital abroad. In the coming years, the United States will be hard pressed to continue doing this. In its place, Japan will be capable of becoming a large importer of goods and a large exporter of investment capital. U.S. relations and influence in Asia, thus, will be affected by this role reversal.

A major loss of U.S. influence, however, is not necessarily inevitable or irreversible. A key uncertainty is whether Japan will or even can substantially open its economy to imports. Additionally, as the United States reduces its current account deficit to a more sustainable level, the U.S. international competitive position

should improve. This, in turn, could help reverse a growing perception in East Asia that the United States is in decline.

3. *A stronger and more independent Japan.* Perhaps the most disagreement among the experts lay in whether a stronger and more independent Japan that was increasingly influential in global and regional affairs would be inimical or complementary to U.S. national interests. One view was that barring any large-scale and unexpected world financial or energy shocks, Japan will remain tied into the post-war structure of political and economic relations in which the United States remains the linchpin.

A contrary view emphasized Japan's enormous drive to be number one, the ability of its political system to methodically determine its own national interests, and then to single-mindedly act on them. The deepest fear was that if current economic trends persist, the United States could be living under a Japanese "empire" by the turn of the century where 30 percent of American assets would be Japanese-owned and the U.S. Secretary of State would have to check with Tokyo before making any significant foreign policy decision. Along these same lines, concern was expressed that Japan might try to put together an Asian trading bloc that excluded the United States, particularly if the newly unified European Community and Canadian-U.S. free trade agreement are seen to undercut its commercial interests.

4. *Limits to U.S. market-opening measures.* Efforts to expand U.S. exports through an aggressive approach toward foreign trade barriers is important for both economic and political reasons. Yet, the political systems in East Asia have limits on how fast they can liberalize, particularly in agriculture and in countries such as Korea, Taiwan, and Thailand where democratization is occurring. The implication is that it will become even more difficult for the United States to craft market opening measures that avoid major political consequences, including rising anti-Americanism, and still achieve the objective of those initiatives.

5. *Generational change.* One recurring theme was that the future generation of Asian leaders, particularly Japanese, was likely to be less pro-American than today's leaders. One participant suggested that the difficulties and policy failures in dealing with past and current pro-American leaders would be greatly magnified when the new generation takes power.

POLICY RECOMMENDATIONS

1. *Reduce the U.S. trade deficit through changes in macroeconomic policy.* There was broad agreement among workshop participants on the desirability of reducing the U.S. current account and merchandise trade deficits through changes in macroeconomic policy. While a sharp reduction in the U.S. trade deficit often was cited as a necessary step to curb a growing Asian perception of American decline, there was much less agreement among the panelists on whether changes in macroeconomic policy alone were sufficient to enhance American influence in Asia. Some participants emphasized the need for U.S. political and managerial leadership to better manage America's vast productive resources and to instill an overall national purpose in remaining an economic superpower.

2. *Devote more resources to meeting the East Asian (to wit, Japanese) challenge.* There was a general consensus that the U.S. resource commitment, both public and private, to meeting the East Asian challenge was inadequate. Specifically, the notion that Japan is an economic superpower and the implications that status has for long-term U.S. interests deserves much more attention from the media, Government, and private sector. In contrast to the resources devoted to coming out on top vis-a-vis the military challenge posed by the Soviet Union, it was argued that the United States gives short shrift to the importance of maintaining economic strength as a component of national security. While polling data were cited as evidence that the American public is beginning to view economic challenges from abroad as more serious than military threats, the U.S. political process still underestimates the importance of economic strength as a component of national security.

3. *Centralized organizational focus for policymaking.* Numerous alleged shortcomings of U.S. policy towards East Asia in general, and towards Japan and the Asian NICs more specifically, were discussed. U.S. policy towards East Asia was criticized generally for being conceived too narrowly in product and sectoral terms and for failing to integrate trade, security, and technology issues in a comprehensive way. U.S. policy towards the Asian NICs was faulted for failing to appreciate the large differences in policymaking processes and circumstances among Hong Kong, Singapore, Taiwan, and Korea. In dealing with Japan, it was suggested that the United States did not have an adequate infrastructure for proposing and answering fundamental questions about the bilateral relationship. To deal with these deficiencies, a number of panelists proposed a more centralized policymaking apparatus.

4. *Criteria for burden-sharing.* In considering various burden sharing proposals, it was suggested that the means of carrying them out are as often as important as the ends. Reduction of U.S. force strength or other commitments, for example, should be done on the basis of mutual negotiations within the broad political context of the U.S. global security alliance. Saying that "we no longer can afford our commitments," that "it is the fault of unfair Asians," and that "it is time they take care of their own burdens" was considered a much less appropriate way to address the issue. In addition, the observation was made that the United States is not in East Asia to protect Asians per se, but is there because it is our western-most line of defense.

EAST ASIA: CHALLENGES FOR U.S. ECONOMIC AND SECURITY INTERESTS IN THE 1990'S

WEDNESDAY, JUNE 29, 1988

**HOUSE OF REPRESENTATIVES, THE CONGRESSIONAL RE-
SEARCH SERVICE OF THE LIBRARY OF CONGRESS, THE
WOODROW WILSON INTERNATIONAL CENTER FOR SCHOL-
ARS, AND THE COMMITTEE ON WAYS AND MEANS,**

Washington, DC.

The workshop met at 9 a.m., in the east dining room, James Madison Building, Library of Congress, Robert Sutter and Raymond Ahearn (of the Congressional Research Service) presiding.

**ROBERT SUTTER, CHIEF, FOREIGN AFFAIRS AND NATIONAL
DEFENSE DIVISION, CONGRESSIONAL RESEARCH SERVICE,
LIBRARY OF CONGRESS**

Mr. SUTTER. My name is Robert Sutter. I am Chief of the Foreign Affairs and and National Defense Division at the Congressional Research Service. On behalf of Joe Ross, the Director of CRS, who is unable to be here this morning, I want to welcome you to our workshop today on East Asia: Challenges for U.S. Economic and Security Interests in the 1990s. We are very pleased to have a workshop on this important issue for the U.S. Congress.

A workshop is something that CRS does in order to provide an opportunity for people with different perspectives to get together and to analyze and review important issues that face U.S. policy in different parts of the world. East Asia clearly is a very, very important part of the world for U.S. policy. Looking at the people around the table, I think it is clear that we're going to have a very lively discussion on a whole range of issues.

I want to congratulate, in particular, Ray Ahearn for putting together a very diverse and very useful program. The program, however, is very compact so we're going to be moving pretty fast today through a series of issues.

I should add that this workshop is being cosponsored by other institutions: The Woodrow Wilson International Center for Scholars and the House Ways and Means Committee. We collaborated with these two institutions last year on a workshop devoted to management of the U.S.-Korean trade conflict. We look forward to further cooperative efforts with them and with other institutions in the Washington area.

Now without further adieu, I'd like to turn over the program to Ray Ahearn.

PANEL 1.—EAST ASIA: A GROWING CENTER OF WORLD ECONOMIC POWER

DISCUSSION LEADER: Randall S. Jones, International Economist, Planning and Economic Analysis Staff, U.S. Department of State

COMMENTATORS:

Roger Severance, Director, Office of the Pacific Basin, U.S. Department of Commerce

Marcus Noland, Research Associate, Institute for International Economics, Washington, D.C.

MODERATOR: Raymond J. Ahearn, Specialist in Asian Affairs, Congressional Research Service

Mr. AHEARN. Thank you, Bob. As you are well aware, I have had a great deal of help from you and others in putting this program together. In fact a number of people in the room today have offered suggestions on the content and design of today's program. So I am quite willing to accept credit as well as share any criticism for possible shortcomings in the program. [Laughter.]

The main purpose of the workshop is to explore what is commonly called the East Asian challenge. We all know that countries in East Asia led by Japan are experiencing increasing economic power and political influence. Our task today is to better understand the trends that are transforming the region and to explore how these changes are affecting U.S. relations with the region.

The agenda for today's program is included in your packet of materials. Our first panel today will explore the issue of East Asia as a growing center of economic power. Randall Jones of the State Department has prepared a paper which evaluates the rise in East Asian economic power and questions whether it's an opportunity or threat to U.S. interests.

Our second panel will look at the issue of East Asia as a regional trading bloc. Ed Lincoln of Brookings has prepared a paper that assesses intra-regional economic trends and the forces both for and against the creation of a regional trading bloc. Whether such a bloc would be led by Japan and be discriminatory in nature remain key questions.

Our last panel this morning will focus on the interaction of economic challenges and political forces that are shaping the policy decisions of Taiwan, Korea, Hong Kong, and Singapore. Stephan Haggard from Harvard will be our discussion leader for this panel.

After lunch, we will examine some of the implications of these broad economic and political trends for selected U.S. interests. The first panel will focus on Japan as a superpower, and here we have a division of labor between Kent Calder and Ron Morse. Kent's paper evaluates Japan's growing international economic power and the implications it has for U.S. interests. Ron's paper focuses more directly on key domestic constraints Japan confronts in defining and playing a larger global role.

The second panel in the afternoon addresses security issues raised by the East Asian challenge. Michael Chinworth of the MIT-Japan program will examine the interaction of security and economic issues from the perspective of Japan with implications for U.S. security commitments.

The last panel of the day will evaluate the efficacy of U.S. trade actions and policy in opening up East Asian markets to U.S. ex-

ports. We are pleased to have Steve Cohen from American University with us to lead that discussion.

Before we begin I'd like briefly to go over the ground rules for the workshop. First, the discussion is being recorded and an edited version of the transcript will be made available in a committee print form by the Committee on Ways and Means. Therefore, all speakers need to identify themselves for the record. It is also helpful to identify yourselves so people have a better sense of who is here and what perspectives are being reflected.

Finally, a few words concerning time allotments for each speaker. Each panel will run about one hour so I'm asking each discussion leader to take about 15 minutes to summarize the main points of their statements and each commentator to limit his or her remarks to less than 10 minutes. That should leave us with 20 to 25 minutes per panel for open-ended questions and discussion. We have a lot of people in the audience that can contribute so there should be no need for any of us to filibuster. On that note, I would like to turn to our first panel.

Our discussion leader is Randall Jones. He is an International Economist with the Planning and Economic Analysis Staff of the Department of State and was educated at Brigham Young University and the University of Michigan. His research interests include the economic history of Asia and U.S.-Japan economic relations. He previously worked at the Japan Economic Institute and the Council of Economic Advisers. Randy has lived in both Japan and Korea, and he reads, writes, and speaks both Japanese and Korean. Fortunately, he has agreed to address us in English. [Laughter].

Dr. Jones, please begin.

STATEMENT OF RANDALL S. JONES, INTERNATIONAL ECONOMIST, U.S. DEPARTMENT OF STATE

Mr. JONES. I'd like to begin by briefly reviewing some of the statistics that suggest that East Asia is in fact a growing center of world economic power. In my paper I've included a few charts. The first one indicates that the rate of economic growth in East Asia during the past 25 years has been much faster than the United States and the rest of the world. As Ray Ahearn suggested, I defined East Asia as Japan, China, the four Newly Industrializing Countries (NIC's) of Asia (Taiwan, South Korea, Hong Kong, and Singapore), the four major ASEAN countries (Malaysia, Thailand, Indonesia, and the Philippines) and Australia and New Zealand.

Naturally, given its high rate of growth, East Asia's share of world output has also increased, as is shown in Figure 2. In contrast, the United States share has declined to about one-fourth of world output. The third chart shows world export shares. Here again, East Asia's share has risen sharply—nearly doubling from 12 percent in 1960 to about 22 percent in 1986.

The growing importance of East Asia to the United States is reflected in the expansion of trade. The 12 East Asian countries accounted for about one-fourth of U.S. exports in 1987, while supplying two-fifths of U.S. imports. The growing economic interdependence between East Asia and the United States is also reflected in the expansion of foreign investment. Japanese capital flows have

played a major role in recent years. With U.S. private saving insufficient to fund both private investment and large government budget deficits, Japanese capital inflows have helped sustain the U.S. economic expansion in the 1980s. In addition, over 40 percent of Japan's direct foreign investment in FY 1987 was in the United States.

With current trends suggesting that East Asia will surpass other regions of the world in a variety of economic, financial, and technological indicators, it has become a common cliché to say that the next century will be the "Pacific century." In reading in preparation for this conference, though, I was surprised at how often that East Asia's economic success is viewed as a threat to the United States. Let me give you a few examples of what I mean. Earlier this year, *Newsweek* magazine had a cover story entitled "The Pacific Century." It began with the statement "As the year 2000 approaches, Japan and the other trading powers of Asia are moving into position to dominate the world economy. For Americans, adapting to the loss of U.S. preeminence will pose unprecedented challenges." Later, the article predicts that East Asia's share of world GNP will surpass that of the United States by the turn of the century.

Another example is a recent poll that said 57 percent of the respondents believe that economic competitors will pose a greater threat to U.S. national security than its military adversaries. Much of this concern is undoubtedly the result of the large trade imbalance between East Asia and the United States.

The United States had a \$105 billion deficit with the 12 East Asian countries, which accounted for three-fifths of the record \$171 billion U.S. trade deficit in 1987. Imports from East Asia are blamed for the decline of major U.S. industries and have led to fears that the United States is deindustrializing, despite the fact that the manufacturing sector continues to account for about 20 percent of GNP. Increased foreign investment in the United States, which is the mirror image of the trade deficit, has also become a major issue. The surge of investment from abroad, particularly Japan, has led to fears that the United States is losing its economic sovereignty. In California and Hawaii, for example, political leaders are pushing for restrictions on Japanese purchases of real estate.

While the contentious trade and investment issues help explain why East Asia is viewed as a threat to the United States, I think the concern is greatly exaggerated for several reasons. First, the nations in East Asia do not constitute a unified economic or political bloc. There have been many initiatives aimed at fostering greater cooperation in the Pacific Basin. Although there has been some progress, the goal of a "Pacific economic community" remains little more than an interesting concept. The great diversity of the nations in East Asia is one factor that inhibits greater unity. There are vast differences in the size of the countries and their level of economic development, type of economic system, and natural resource endowments that complicate relations between countries.

Figure 4 of my paper shows the wide range in per capita income levels. At current exchange rates, Japan's per capita GNP is over \$19,000 per year, while China's is less than \$500 per year. The eco-

conomic systems in the region range from laissez-faire to largely centrally-planned systems, resulting in sharp ideological and political differences. In addition to the great diversity, the smaller countries' fear of domination by the larger ones, specifically Japan and China, is a second obstacle to increased cooperation.

Finally, the trade barriers maintained by many of the East Asia countries also hinder greater cooperation. ASEAN, for example, decided in 1976 to lower barriers to trade within the ASEAN countries. Intra-ASEAN trade, though, still accounts for only about one-fifth of its members' total trade. Even that figure is somewhat misleading since oil and petroleum products account for half of intra-ASEAN trade.

Figure 5 shows the level of trade within the East Asian region. Japan's large purchases of raw materials make it the largest market for ASEAN. South Korea and Taiwan, though, sell more to the United States than they do to Japan and the rest of East Asia combined. Japan is also dependent on the U.S. market, which accounts for almost 40 percent of its exports. For the 12 East Asian nations, shipments to the United States accounted for 33 percent of their combined exports in 1986, nearly matching the 35 percent that was exported to other countries in the region.

The relatively low share of intra-regional trade contrasts sharply with the 12-nation European Community. In 1986, exports to other EC countries accounted for about 60 percent of the total exports from EC-member countries.

Given this great diversity, I think it is inaccurate, at least at the present time, to view East Asia as a unified economic bloc that is threatening the United States. From this point of view, it doesn't make much sense to compare the combined GNP of East Asia or the combined exports of East Asia, in relation to the United States. Moreover, even if East Asia were to become a unified bloc, it's economic success, I believe, would present more of an opportunity than a threat to the United States.

The rapid development of its East Asian allies has been a major objective of U.S. foreign policy in the postwar era. To avoid the mistakes that were made in the inter-war period, the United States took the lead in establishing an open international economic system that encouraged flows of trade, technology, and investment across national borders.

The open international system has made possible the increased integration of the world's economy. Integration takes many forms. Since 1950, there has been more than a nine-fold increase in the volume of world exports. The expansion of trade has been accompanied by a surge in international investment. The daily volume of foreign exchange transactions is now estimated at more than \$1 trillion. The growing international exchange of technology is another evidence of integration. In addition, the process of production has begun to spill over national boundaries. The European version of the Ford Escort, for example, is assembled from parts manufactured in 15 different countries. Another example is a shipping label that was attached to an integrated circuit fabricated by a U.S. firm. This shipping label read: "Made in one or more of the following countries: Korea, Hong Kong, Malaysia, Singapore, Taiwan,

Mauritius, Thailand, Indonesia, Mexico, Philippines. The exact country of origin is unknown."

One consequence of world economic integration has been a narrowing of economic differences between countries. At the end of World War II, Japan and much of Europe was devastated by war, and the developing world was still in severe poverty. United States leadership was unchallenged. But as a result of international flows of trade, investment, and technology, the level of productivity and per capita income has been converging across countries. This is particularly evident in the East Asian countries, which have pursued relatively open and outward-oriented policies.

The rising share of world output accounted for by East Asia is a natural consequence of the open international system established after World War II. The rise of Asia, though, does not necessarily imply the decline of the United States in absolute terms. Instead, convergence has been generally good for the United States. A nation benefits from rising incoming levels in its trading partners. A richer country produces more of what we want to buy, and it buys more of what we produce. Moreover, economic development has helped produce a more stable political environment in East Asia.

Although the deterioration of the U.S. trade balance is basically a macroeconomic problem, that has been primarily made in the United States, it is often blamed on the trade policies of countries in East Asia. Trade barriers in most of the region though have fallen in recent years, in contrast to the trend toward higher barriers in other parts of the world. As a result of their strong growth and trade liberalization measures, the 12 East Asian countries accounted for more than three-fourths of the increase in total U.S. exports between 1981 and 1987. Instead of a threat, the economic emergence of East Asia offers enormous new opportunities for the United States and the rest of the world. Of course, to take advantage of those opportunities, the United States must be willing to undergo sometimes difficult economic adjustments.

In speculating on the outlook for East Asia, it is tempting to concentrate on Japan, which accounts for about two-thirds of the economic output of the region and almost one-half of its exports. In addition to being a major industrial country, Japan is also an important financial center, given its status as the world's largest creditor nation with \$241 billion in net foreign assets. But it is important to include the other East Asian nations as well, since competition between the countries plays an important role in the region. The East Asian nations are characterized by a variety of stay-ahead and catch-up strategies. The leader, Japan, is facing increased competition from the other East Asian nations. The hourly compensation cost and the manufacturing sector in Japan in 1987 was quite high—at \$11.34, compared to the NICs where it ranged from only \$2.37 to \$1.69.

The NICs, in turn, are facing challenges to their export competitiveness from the ASEAN countries and China. The four Asian NICs have become major players in world trade. In 1986, Taiwan was the tenth largest exporting nation, while the other three all ranked in the top 20. Rapidly increasing labor costs, though, are threatening the NICs' export competitiveness. Wages in South

Korea increased about 17 percent last year. Unions are pushing for an even larger increase this year. In addition, their currencies, with the exception of the Hong Kong dollar, have appreciated against the U.S. dollar in the past year and further increases are likely.

To stay competitive, firms in the NICs have begun the familiar strategy of producing offshore in lower-wage countries. Outstanding investment in the ASEAN countries by the NICs is already 40 percent of the Japanese total. As the NICs are forced to cede the lower end of product lines to the developing countries, they will face the challenge of moving upscale into more technologically advanced products. This will require greater expenditures on research and development, especially since Japan and the other advanced countries are worried about the boomerang effect; that is, that exports of technology will come back to haunt them in the form of increased competition from the NICs.

At a third tier below Japan and the NICs are the ASEAN countries. Although they are major producers of primary products, the ASEAN countries' exports of manufactured products have increased rapidly. Several of the more advanced ASEAN countries, notably Thailand and Malaysia, will likely join the ranks of the NICs in the 1990s.

Finally, there's China, which has been greatly influenced by the economic development of its East Asian neighbors. In the late 1970s, China's leaders decided that the country's isolation was one of the primary causes of its stagnation, and decided to pursue a more open policy. The resulting increase in trade, investment, and technology, is helping China get the same economic uplift that Japan, the NICs, and the ASEAN countries have experienced. During the first half of the 1980s, China's economy grew at an annual real rate of almost 10 percent.

For the region as a whole, it is likely that the two factors that have played a major role in encouraging rapid growth will continue in the future. Perhaps the most important is the continued emphasis on outward-oriented policies, in contrast to the more self-sufficient policies pursued by many LDCs. Second is the willingness of most nations in the region to sacrifice current consumption in favor of high rates of investment.

The availability of foreign markets, particularly the United States, has been a third major factor in East Asian development. U.S. imports of manufactured goods from the 12 East Asian countries increased from \$66 billion in 1981 to \$162 billion in 1987—that's an annual rate of almost 15 percent. Given the large U.S. trade deficit, though, it's not likely that the United States can continue to absorb such rapid increases in exports from East Asia. With the growth in U.S. imports slowing, continued rapid growth in East Asia may depend on Japan's willingness to absorb more manufactured imports from its neighbors. The sharp appreciation of the yen is pushing Japan in that direction. Japan's imports of manufactured goods have increased by about one-third in volume terms during the past two years. According to a recent Ministry of International Trade and Industry survey, 6 out of every 10 black and white TVs sold in Japan are now imported. Five out of every 10 calculators are imported. Four out of every 10 radio cassette

decks and 35-millimeter cameras sold in Japan are imported. As for cars, 3 out of every 100, not 10, are now imported.

Many of these products are made in NICs. Japanese imports of manufactured goods from the NICs increased about 60 percent last year. Direct foreign investment by Japanese firms has helped the other East Asian countries gain a foothold in Japan's market. The continuing trend toward offshore production is likely to be a key factor in boosting Japan's imports of manufactured goods.

Becoming a major market for East Asian imports will require major structural changes in Japan's economy. Other countries in the region still complain that Japan is closed to many of their products and that Tokyo's import liberalization measures have been focused on appeasing the United States and other advanced countries. The manufacturing sector still accounts for about 30 percent of Japan's GNP—a relatively high figure relative to other advanced countries. The shift to the service sector is epitomized by Nippon Steel's plan to transform an idle steel plant into a "Leisureland" amusement park. The transformation of Japan's industrial structure will be complicated by a second major trend, the aging of Japan's population, which is likely to be more severe in Japan than in the other advanced countries.

In conclusion, the emergence of East Asia is viewed with a mixture of admiration and fear in the United States. The fear is that the United States will soon be confronted by a larger, more powerful, and more influential economic bloc. I think this pessimistic outlook is exaggerated, since East Asia is a diverse group of nations rather than a unified economic bloc. Moreover, the economic relationship between the United States and East Asia is not a zero sum game. Both sides can benefit from economic interdependence. Economic interdependence, though, has also meant increased competition for sectors of the U.S. economy. There has been a rise in the political pressure for protectionism in recent years. Resorting to protectionism would be a serious mistake. China, Japan, and Korea have each tried to shut out the rest of the world at various times in their history and each has paid a heavy price. A more beneficial approach to meet the challenge posed by East Asia is increased investment by the United States in plant and equipment, research and development, and human capital that will boost the productivity of U.S. workers and raise the standard of living in the United States. Thank you.

Mr. AHEARN. Thank you Randy. Your prepared statement will be inserted in the record.

[The prepared statement follows:]

PREPARED STATEMENT OF RANDALL S. JONES, INTERNATIONAL ECONOMIST, U.S.
DEPARTMENT OF STATE

EAST ASIA: A GROWING CENTER OF WORLD ECONOMIC POWER

The rapid growth of the East Asian countries has made the region an important center of world trade and economic activity. The region's economic emergence has been led by Japan, which is now the world's largest creditor nation with \$240 billion in net foreign assets. At current exchange rates, the level of per capita income is higher in Japan than in the United States, although it still lags behind on a purchasing power parity basis. Japanese technology is at the forefront in such areas as biotechnology, robotics, and ceramics.

The developing countries of East Asia have significantly outperformed other less developed countries (LDCs), particularly since the first oil shock in 1973. The four newly industrializing countries (NICs)—Taiwan, South Korea, Singapore, and Hong Kong—have achieved high and sustained growth rates since the early 1960s. Like Japan, the NICs have become important players in world trade. In 1986, Taiwan was the tenth-largest exporting nation, while Hong Kong, South Korea, and Singapore were all in the top twenty. Together they account for more than two-thirds of total LDC exports of manufactured goods.

Following the NICs, Indonesia, Malaysia, the Philippines, and Thailand, which are all members of the Association of Southeast Asian Nations (ASEAN), picked up considerable growth momentum in the 1970s. Although the ASEAN countries are major producers of primary products, their exports of manufactured goods have grown faster than those of other developing nations outside of Asia.

China has been greatly influenced by the economic dynamism of its East Asian neighbors. After nearly thirty years of isolation, China's leaders decided in the late 1970s that the country's closed-door policies were a primary cause of its stagnation. China has since opened its doors to increased trade, investment, technology, and tourism, hoping to get the same economic uplift that Japan, the NICs, and the ASEAN countries have experienced. The Chinese economy responded with real growth at an annual rate of close to ten percent during the first half of the 1980s.

The region also includes two advanced countries, Australia and New Zealand, which are major exporters of farm products and raw materials. Although Australia and New Zealand are more Western than Asian, they have become increasingly linked to other countries in the region through trade. In 1960, East Asia and the Pacific accounted for only 30 percent of Australia's exports, while 52 percent went to North America and Europe. In 1977, those shares were reversed.¹

The Pacific Century?

Although the region has its lagging performers, East Asia is the most dynamic region of the world. Between 1960 and 1986, economic output in East Asia—Japan, China, Australia, New Zealand, the NICs, and the four ASEAN nations—increased at twice the 3 percent real annual rate recorded by the United States (see Figure 1). As a result, the region's share of world output has nearly doubled since 1960, while the U.S. share has fallen to less than one-fourth (see Figure 2).

East Asia's significance in the world economy is also reflected in its rising share of international trade. Between 1960 and 1986, the region's share of world exports nearly doubled to 22 percent (see Figure 3). The export surge was concentrated in manufactured products. By 1985, Japan accounted for 15 percent of world manufactured exports, while the NICs share had risen to 9 percent.²

The importance of East Asia to the U.S. economy is reflected in the expansion of trans-Pacific trade, which surpassed trans-Atlantic trade in 1984.³ The twelve East Asian countries accounted for over one-fourth of U.S. exports in 1987 and supplied over two-fifths of U.S. imports (see Table 1). The United States was the largest export market for eight of the twelve countries.

The growing economic interdependence of the United States and East Asia is also reflected in the expansion of foreign investment, both portfolio and direct. Almost one-half of Japan's direct foreign investment in FY 1986 was in the United States. Japanese capital flows have played a key role in the U.S. economic expansion during the 1980s. With U.S. private saving insufficient to fund both private investment and large government budget deficits, Japanese capital inflows have benefited the United States by preventing further increases in U.S. interest rates.

With current trends suggesting that East Asia will surpass other regions of the world in a variety of economic, financial, and technological indicators, many observers have concluded that the next century will be the "Pacific Century." But whereas some see that development as an opportunity, others view it in more ominous terms. A recent *Newsweek* article for example, stated that "As the year 2000 approaches, Japan and the other trading powers of Asia are moving into position to dominate the world economy. For Americans, adapting to the loss of U.S. preeminence will pose unprecedented challenges . . .".⁴

¹ Whitlam, E. Gough, *A Pacific Community*, Cambridge, MA: Harvard University Press, 1981, p. 39.

² Watanabe, Toshio, "Asia: New Frontier of Economic Growth," *Economic Eye*, Vol. 9, No. 1, March 1988, p. 39.

³ General Agreement on Tariffs and Trade, *International Trade 1984/85*, Geneva, 1985, p. 15.

⁴ *Newsweek*, "The Pacific Century," February 22, 1988, p. 43.

Much of the concern is a result of the trade imbalance between the East Asian countries and the United States, which accounted for three-fifths of the record \$171 billion U.S. trade deficit in 1987 (see Table 2). Import competition from Asia is blamed for the troubles of major domestic industries and has contributed to fears that the United States is deindustrializing (despite the fact that manufacturing continues to maintain its historical 20 percent share of gross national product). Increased foreign investment in the United States, which is the mirror image of the trade deficit, has also become a major issue. The surge in investment from abroad, particularly from Japan, has led to complaints that the United States is losing its economic sovereignty. In California and Hawaii, for example, local leaders are pushing for restrictions on Japanese purchases of real estate.

The concern over competition from East Asia is reflected in a recent poll in which 57 percent responded that in ten years economic competitors will pose a greater threat to U.S. national security than its military adversaries.⁵ This position apparently has some support among political leaders as well. At a 1986 Joint Economic Committee hearing, a leading congressman noted that the Eastern Bloc has traditionally been perceived as the major international rival to the United States. He warned, though, that "Now it is clear that another challenge—just as important and just as real—will be coming from the Pacific Rim."⁶

Viewed as one huge economic bloc, East Asia, with its 1.6 billion people and dynamic economies, may appear to pose a threat to the United States. But first, it is important to consider whether the twelve nations of East Asia do, in fact, constitute an economic or political community.

The Prospects for a Pacific Economic Community

There have been many initiatives aimed at promoting economic and political cooperation in the Pacific region. In 1968, the Pacific Basin Economic Council and the Pacific Trade and Development Conference were established. In 1980, the Pacific Economic Cooperation Conference, which brings together government, business, and academic leaders, was organized.

At this point, though, a "Pacific Economic Community," is little more than an interesting concept. The great diversity of the nations in East Asia remains one factor inhibiting greater unity. Profound cultural, racial, and religious differences complicate relations between countries. In addition, there are vast differences in the size of the countries and their level of economic development, type of economic system, and natural resource endowments. The level of per capita annual GNP ranges from Japan at over \$19,000 to China at under \$500 (see Figure 4). The region includes the world's most populous country, China, with over one billion people, and Singapore, a small city-state with a population of less than three million. Economic systems in the region range from laissez-faire to largely centrally-planned. The lack of political ties between China and two of its closest neighbors, Taiwan and South Korea, obviously inhibits regional cooperation. Perhaps the most significant common element is the above-average economic performance of most nations in the region during the last few decades.

The smaller countries' fear of domination by the larger ones is a second obstacle to increased cooperation. The Southeast Asian nations, many of which have sizable ethnic Chinese populations, are wary of greater influence from China. In addition, Japan, which accounts for two-thirds of the GNP produced by the twelve East Asian nations' is still viewed with suspicion by many of the other countries. Moreover, Japan has shown a reluctance, at least in the past, to play a major international role. In addition, Tokyo tends to identify itself more strongly as a member of the Western alliance than as an Asian nation.

The trade barriers maintained by many of the nations in East Asia also hinder closer economic integration. Although ASEAN formally decided to pursue economic cooperation in 1976, intra-ASEAN trade still accounts for only about one-fifth of its members' total trade. Even that figure is misleading since over one-half of intra-ASEAN trade is in crude oil and petroleum products. In 1986, the ASEAN states decided to delay the goal of free trade among members until the year 2000.

Japan's large purchases of raw materials make it the largest export market for ASEAN. Two of the major exporters in the region, Taiwan and South Korea, though, sell more to the United States than they do to Japan and the other East Asian nations combined (see Figure 5). Japan is also dependent on the U.S. market, which accounts for almost 40 percent of its exports. For the twelve East Asian na-

⁵ *Wall Street Journal*, May 16, 1988, p. 7.

⁶ Obey, David R. "Introductory Remarks," *Symposium on U.S.-Pacific Rim Relations* (hearings before the Joint Economic Committee), December 121, 1986, p. 7.

tions, shipments to the United States accounted for 33 percent of their combined exports in 1986, nearly matching the 35 percent that was exported to other countries in the region. The relatively low share of intra-East Asian trade contrasts with the pattern of trade in the 12-nation European Community (EC). In 1986, exports to other EC countries accounted for 57 percent of total exports by the member countries.

The United States continues to deal with the East Asian nations primarily on a bilateral basis rather than as a regional bloc. But the region has moved in the direction of greater cooperation and more progress is likely in the future. Robert A. Scalapino, for example, states that "regionalism, both in terms of specific subunits and the entire Pacific-Asian area, is the wave of the future."⁷ Former Japanese prime minister Yasuhiro Nakasone is pushing for a "Pacific Forum for Economic and Cultural Cooperation," which he describes as a "Pacific OECD" consisting of all countries in the region."⁸

An organization that could create increased flows of trade, capital, and technology between the nations of East Asia would certainly benefit the region. It would promote the more efficient use of resources and encourage greater economies of scale. Moreover, it would be a hedge against the threat of American protectionism. While the advantages to the region are clear, the impact on the United States is less certain. A more unified East Asian bloc, with a combined GNP that is likely to exceed the U.S. GNP by the end of the century, would certainly heighten the concern of those who view the region as a threat to the economic well-being of the United States.

The Benefits of an Open International Economic System

To put the Asian "threat" in perspective, it is useful to consider the world economy in the immediate post-World War II era. With Japan and much of Europe devastated by war and severe poverty prevailing in most of the developing world, U.S. leadership was unchallenged. To avoid the mistakes of the interwar period, the United States took the lead in establishing an open international economic system that encouraged flows of trade, capital, and technology across national borders.

The open system has made possible the increased integration of the world economy during the past 40 years. Since 1950, there has been a more than nine-fold increase in the volume of world exports. The expansion of trade has been accompanied by a surge in international investment; the daily volume of foreign exchange transactions is now estimated at more than \$1 trillion. The growing international exchange of technology is another evidence of integration.

In addition, the process of production has begun to spill over national borders. The IBM personal computer, for example, consists of parts manufactured in the United States and three Asian countries. Another example that is often cited by Secretary of State George P. Shultz is a shipping label that was attached to an integrated circuit fabricated by an American firm. It read, "Made in one or more of the following countries: Korea, Hong Kong, Malaysia, Singapore, Taiwan, Mauritius, Thailand, Indonesia, Mexico, Philippines. The exact country of origin is unknown."⁹

One consequence of world economic integration has been a narrowing of economic differences between nations. As a result of international flows of investment and technology, the level of productivity and per capita income is converging across countries. This is particularly evident in the East Asian nations, which have pursued relatively open and outward-oriented policies.

The rising share of world output accounted for by East Asia is a natural consequence of the open international system established after World War II. The rise of Asia, though, does not imply the decline of the United States in absolute terms. Instead, convergence has been good for the United States. A nation benefits from rising levels of income in its trading partners. A richer partner produces more of what the United States wants to buy and buys more of what the United States produces. The export-oriented development strategies pursued in many nations in East Asia have also promoted their imports of capital and intermediate goods. Moreover, economic development has helped create a more stable political environment in the region.

Although the deterioration in the U.S. trade balance is essentially a macroeconomic problem that was primarily made in the United States, it is sometimes

⁷ Scalapino, Robert A., "Asia's Future," *Foreign Affairs*, Fall 1987, p. 104.

⁸ The idea was presented in a speech by Mr. Nakasone at the "Pacific Future Forum," March 14, 1988.

⁹ Cited in a speech given by the Secretary on April 28, 1988.

blamed on the trade policies of the East Asian Countries. Trade barriers in most of the region, though, have been lowered in recent years, in contrast to the trend toward higher barriers in other parts of the world. As a result of their strong growth and trade liberalization measures, the twelve East Asian nations accounted for more than three-fourths of the increase in total U.S. exports between 1981 and 1987. Meanwhile, their share of the U.S. trade deficit fell during that period (see Table 2).

Instead of a threat, then, the economic emergence of East Asia offers enormous new opportunities for the United States and the rest of the world. In order to take advantage of that opportunity, though, the United States and other advanced countries must be willing to experience sometimes difficult economic adjustments.

Outlook for East Asia

In general, the factors responsible for the region's rapid development appear likely to encourage continued growth. Perhaps most importantly, the developing countries of East Asia continue to emphasize outward-oriented policies in contrast to the more self-sufficient development strategies pursued by many LDCs. In addition, most nations in the region have shown a willingness to sacrifice current consumption in favor of high rates of investment. Even relatively poor China saves as much as 30 percent of its national income.

Many studies of East Asia's future concentrate on Japan and the four NICs. This is not surprising, since Japan alone accounts for about two-thirds of the region's combined GNP and almost one-half of its exports. Moreover, Japan has become a leading industrial power and financial center and has an extremely important bilateral relationship with the United States. The NICs are important trading countries in their own right, accounting for almost one-third of East Asia's exports. Taiwan has amassed foreign reserves equal to more than one-half of its GNP, while South Korea, which has announced long-term plans to internationalize its capital markets, will likely become a creditor nation early in the 1990s.

Although Japan and the NICs account for a dominant share of output and exports, the other countries in the region should not be ignored. Competition between countries plays an important role in the region's economic dynamism. The East Asian nations are characterized by vigorous catch-up and stay-ahead strategies that will determine the region's future. The leader, Japan, is facing increasing competition from the NICs in both domestic and third-country markets. The \$11.34 hourly compensation cost for production workers in manufacturing in Japan in 1987 was much higher than in the NICs, where it ranged from \$2.37 to \$1.69.¹⁰

The NICs, in turn, are facing challenges to their export competitiveness from the ASEAN countries and China. Rapidly increasing labor costs are threatening the NICs' cost advantage, especially in labor-intensive manufacturing. Wages rose 17 percent in South Korea last year and its unions are pushing for an even larger increase in 1988. In addition, their currencies, with the exception of the Hong Kong dollar, have appreciated against the U.S. dollar in the past year and further increases are expected. To stay competitive, firms in the NICs have begun the familiar strategy of producing offshore in low-wage countries. Outstanding investment in the ASEAN countries by the NICs is already 40 percent of the Japanese total.¹¹ There is also great potential for investment by South Korea and Taiwan in China as the political relationships grow warmer.

Economic reforms and currency depreciation will enable the ASEAN countries and China to benefit from increased direct foreign investment. The recent progress in lowering tariffs that protect import substitution industries will also increase export potential. Many observers expect several of the more advanced ASEAN countries, notably Thailand and Malaysia, to join the group of NICs in the 1990s.

Given the importance of exports in most of the economies in the region, the availability of foreign markets will have a major impact on East Asia. Its manufacturers have benefited greatly from access to the U.S. market, between 1981 and 1987, U.S. imports of manufactured goods from the twelve East Asian countries increased at an annual rate of almost 15 percent. But given its large trade deficit, it is unlikely that the United States can continue to absorb such rapid increases in exports from East Asia. The U.S. trade deficit is made possible by the willingness of foreign investors to continue their lending and investment in the United States. Once they decline to continue making net investments in the United States, the U.S. trade deficit will come to an end (and even move into surplus in order to service its foreign debt).

¹⁰ U.S. Department of Labor, *International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1987*, Report 750, February 1988.

¹¹ Watanabe, p. 28.

An end to the U.S. import boom could adversely affect the East Asian countries dependent on the U.S. market.

With the growth in U.S. consumption of imports slowing, it will fall to Japan to absorb the rising exports of manufactured goods from neighboring countries. The sharp appreciation of the yen is pushing Japan in that direction. Japan's imports of manufactured goods have increased by about one-third in volume terms during the past two years. According to a Ministry of International Trade and Industry survey, imports now account for 60 percent of the black and white televisions sold in Japan, 56 percent of the electric fans, 52 percent of the calculators, and 40 percent of the radio cassette decks and 35mm cameras."¹² A large share of these products are made in the NICs: Japanese imports from the NICs increased about 44 percent last year.

Direct foreign investment by Japanese firms is helping the other East Asian countries gain a foothold in Japan's market. Many of the imports are manufactured in Japanese plants overseas that were originally intended to produce for local consumption or export to third markets. The continuing trend toward offshore production is likely to be a key factor in boosting Japanese imports of manufactured products.

Becoming a major market for East Asia's expanding manufactured exports will require structural changes in Japan's economy. Other countries in the region complain that Japan's market is closed to many of their products and that Tokyo's import liberalization measures have been aimed at appeasing the United States and other industrial countries. The manufacturing sector still accounts for 30 percent of Japan's GNP, a relatively high figure for an advanced country. The shift toward the service sector is epitomized by Nippon Steel's plans to transform an idle steel plant into a "Leisureland" amusement park. The transformation of Japan's industrial structure will be complicated by a second major trend, the aging of its population. According to the International Monetary Fund, "The impact of the demographic change on the Japanese economy is likely to be the most extreme among the Group of Seven"¹³

The NICs also face challenges to their continued prosperity, including protectionism abroad and political problems at home. Hong Kong, which is scheduled to revert to Chinese control in 1997 under the "two systems-one country" approach, faces the most uncertain future. In addition, the appreciation of the Korean won, New Taiwan dollar, and Singapore dollar combined with rapidly rising wage rates will force those countries to cede the lower end of product lines to LDCs and move upscale into more technologically-advanced products. With Japan and the advanced countries concerned that exports of technology will result in increased competition from producers in the NICs (the "boomerang effect"). This will require greater expenditures on research and development in the NICs.

The ASEAN countries, China, Australia, and New Zealand have made significant progress in such areas as deregulation, financial liberalization, and reducing import barriers. The difficult internal political challenges facing many of the ASEAN countries, however, pose a threat to continued economic reform. Moreover, the opening of China, one of the most important developments in East Asia during the past decade, could also be threatened by political shifts in Beijing. At this point, though, the debate appears to focus on the speed of reform rather than on whether to reverse the changes that have taken place.

Conclusion

The emergence of powerful economies in East Asia is viewed with a mixture of admiration and fear in the United States. The region's economic success, some observers argue, means that the United States will soon be confronted by a larger, potentially more influential, economic bloc. This pessimistic outlook overlooks the fact that East Asia is a diverse group of nations rather than a unified bloc. Moreover, the U.S. economic relationship with the region is not a zero-sum game. Instead, the growing economic interdependence between the United States and East Asia benefits both sides.

Economic interdependence, though, has also meant intensified competition for sectors of the U.S. economy. As a result, political pressures to protect domestic industries have become stronger in recent years. Resorting to protectionism, though, would be a serious mistake for the United States. China, Japan, and Korea have each tried to shut out the rest of the world at various times in their history, and

¹² Oyama, Hiroto, "Growing Pains," *Look Japan*, April 1988, p. 5.

¹³ International Monetary Fund, *Aging and Social Expenditure in the Major Industrial Countries, 1980-2025*, 1986, p. 8.

each paid a heavy price. A more beneficial approach is increased investment in plant and equipment, technology, and human capital that will boost the productivity of U.S. workers and the standard of living in the United States.

TABLE 1.—U.S. TRADE WITH EAST ASIA

(In billions of U.S. dollars)

Country	U.S. exports		U.S. imports	
	1987	Share of total exports (percent)	1987	Share of total imports
Japan	\$28.2	11.2	\$88.1	20.8
Taiwan	7.4	2.9	26.4	6.4
South Korea	8.1	3.2	18.0	4.2
Hong Kong	4.0	1.6	10.5	2.5
Singapore	4.1	1.6	6.4	1.5
NICs subtotal	23.5	9.3	61.3	14.5
Indonesia8	.3	3.7	.9
Malaysia	1.9	.8	3.1	.7
Philippines	1.6	.6	2.5	.6
Thailand	1.5	.6	2.4	.6
ASEAN subtotal	5.8	2.3	11.6	2.7
China	3.5	1.4	6.9	1.6
Australia	5.5	2.2	3.3	.8
New Zealand8	.3	1.2	.3
Subtotal	6.3	2.5	4.5	1.1
East Asia total	67.4	26.7	172.4	40.6
Worldwide total	252.9	100.0	424.1	100.0

Source: U.S. Department of Commerce.

TABLE 2.—U.S. TRADE BALANCE, 1981 ¹ AND 1987

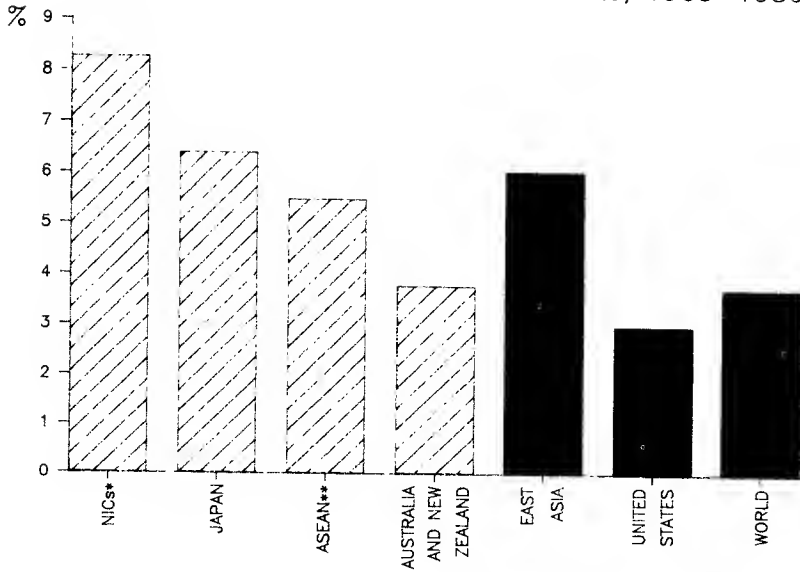
[In billions of U.S. dollars]

Country	1987	Share of total deficit (percent)s	1987	Share of total deficit
Japan.....	-\$18.1	45.6	-\$59.8	34.9
Taiwan.....	-4.3	10.9	-19.0	11.1
South Korea.....	-4	.9	-9.9	5.8
Hong Kong.....	-3.1	7.9	-6.5	3.8
Singapore.....	.8		-2.3	1.4
NICs subtotal.....	-7.0	17.6	-37.7	22.0
Indonesia.....	-5.1	12.19	-3.0	1.7
Malaysia.....	-.7	1.9	-1.2	.7
Philippines.....	-.4	.9	-.9	.5
Thailand.....	.2		-.8	.5
ASEAN subtotal.....	-6.1	15.3	-5.8	3.4
China.....	1.5		-3.4	2.0
Australia.....	2.5		2.2	
New Zealand.....	.1		-.4	2
Subtotal.....	2.6		1.8	
East Asia total.....	-27.0	68.0	-105.0	61.3
Worldwide total.....	-39.7	100.0	-171.2	100.0

¹ The most recent year in which the United States recorded a current account surplus (the sum of the merchandise trade balance, service balance, and net transfers to foreigners).

Source: U.S. Department of Commerce.

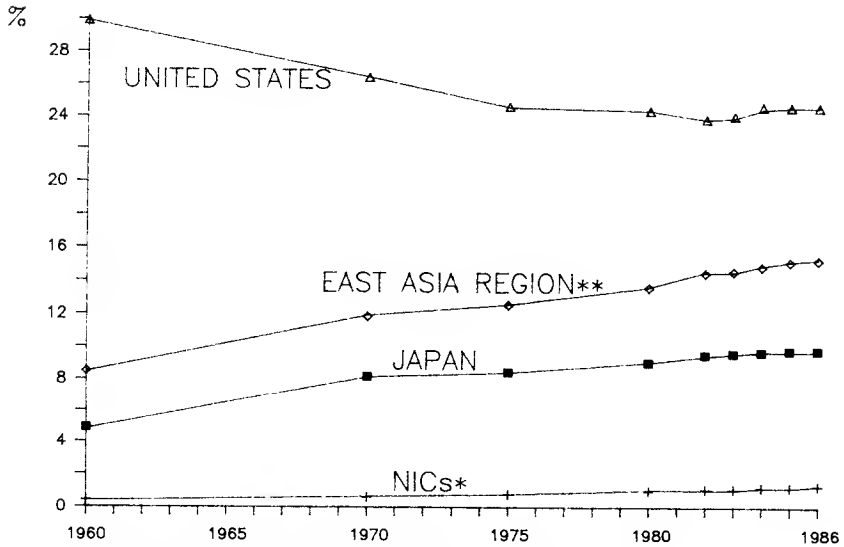
Figure 1: Real GNP Annual Growth Rate, 1960–1986



*Taiwan, South Korea, Hong Kong, and Singapore
 **Indonesia, Malaysia, Thailand, and the Philippines

Source: CIA, Handbook of Economic Statistics

Figure 2: Share of World Output, 1960–1986



*Taiwan, South Korea, Hong Kong, and Singapore
 **Japan, China, Australia, New Zealand, the NICs, and ASEAN (excluding Brunei)

Source: CIA, Handbook of Economic Statistics

Figure 3: World Export Shares, 1960–1986

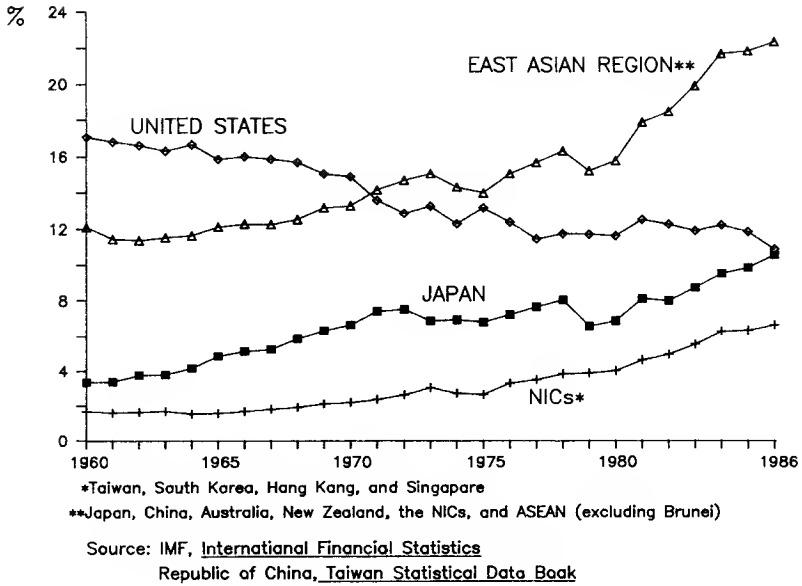


Figure 4: Per Capita GNP in East Asian Countries

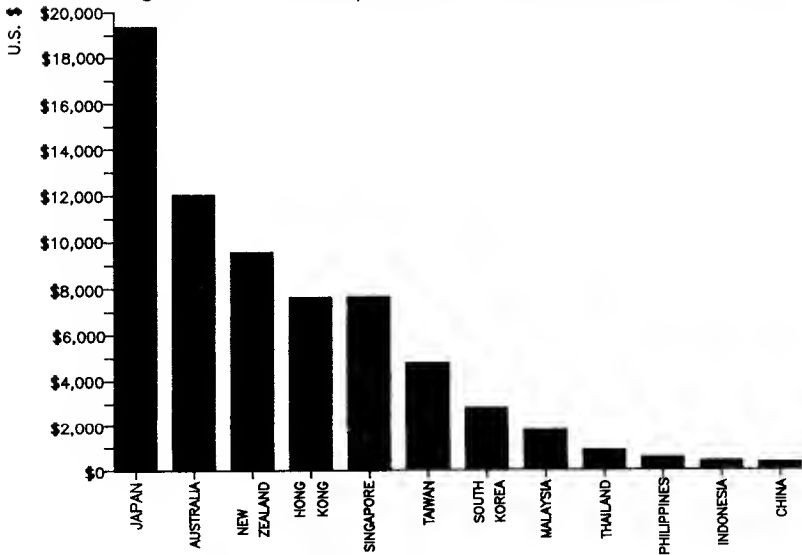
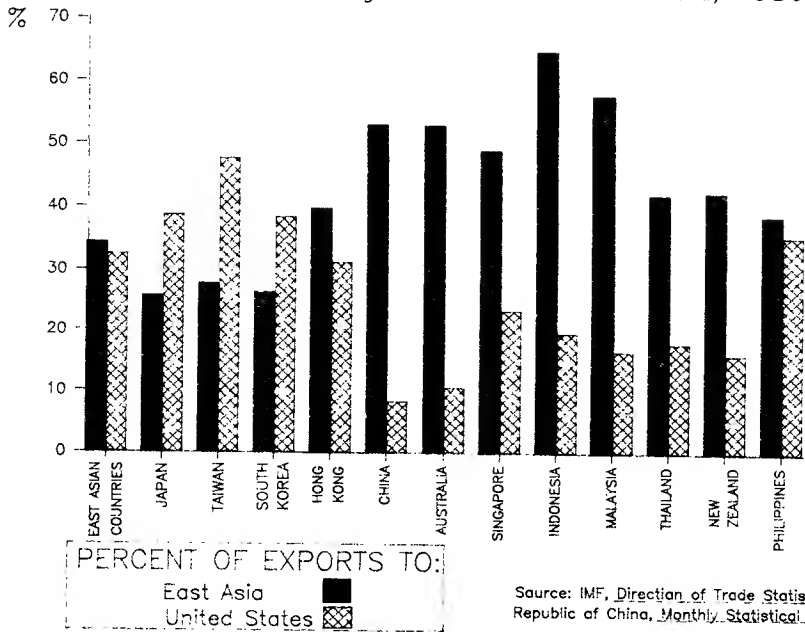
Source: Fortune, March 28, 1988

Figure 5: Intra-regional Trade in East Asia, 1986



Source: IMF, *Direction of Trade Statistics*
 Republic of China, *Monthly Statistical Data*

Mr. AHEARN. We'll turn now to our first commentator, Roger Severance. He is the Director of the Office of the Pacific Basin at the Department of Commerce and has served in that capacity for the past five years. Previously, he held a number of other high-level positions in the Departments of Commerce and State. Mr. Severance has also lived in Asia for extended periods of time. Mr. Severance, please.

STATEMENT OF ROGER SEVERANCE, DIRECTOR, OFFICE OF THE PACIFIC BASIN, U.S. DEPARTMENT OF COMMERCE

Mr. SEVERANCE. Thank you Ray, and thank you, Bob, for inviting me here today. It is always good for us who are in the executive branch, faced with day-to-day problems, to participate in a seminar such as this to give us a little bit of perspective on what is going on. But let me give you the perspective from the Department of Commerce on what is going on in East Asia.

First of all, I would say I agreed generally with Randy's paper and I think he has done a good job in putting a lot of economic developments and trends into some kind of perspective for us, and I certainly commend him on doing that. I also agree with his conclusions that East Asia is not an integrated economic bloc; that it is not something necessarily to fear but offers more of an opportunity for the United States.

I think that there are two major macroeconomic trends going on in Asia today that affect the United States exporter and affect the United States investor. The first is the currency realignments; the second is the buildup of exchange reserves.

The currency realignments have the obvious impact of assisting U.S. exports and making imports from the area more expensive. But the impact is much more than that, and Randy alluded to this. I think that the doubling of the value of the yen has caused a rather large scale shift of investment by the Japanese to other parts of Asia, and we see this particularly happening in places like Thailand, Singapore, and Malaysia. So what you have is Japanese investments in export platform industries such as textiles and electronics in Southeast Asia.

We see the currency realignment reflected in our statistics as our trade deficit with Japan levels off. The currency realignment has not yet had a major impact on other Asian countries as our deficits continue to increase. Also, as a result of currency realignments, substantial investment is taking place in the Philippines, Thailand, and Malaysia. So, the realignment of currencies is leading to a rather rapid shift of investment southward in the area, and this is something that I think has implications for the United States. As we begin to balance our trade more with Japan and, hopefully, with Korea and Taiwan, our trade imbalances should shift southward with the consequent pressures on us to do more for American industry in those countries in terms of market access and removal of investment restrictions.

The other important development is the buildup of exchange reserves in Japan, Korea, and Taiwan, which really is a positive development for American exporters, as it leads to more market

opportunities in those countries. And I submit that is a beneficial effect.

The shift southward of investment and resulting exports from these countries exacerbates what I call the Japan-diversion problem. I do not think that we have thought enough about the fact that not only does Japan maintain these import restrictions, but these restrictions divert other Asian country exports to the United States. In fact, most of Asian countries export twice as much to the United States as they do to Japan. Businessmen make major selling efforts in the United States because the United States, even though we do have our import restrictions, is probably the most open market in the world today. So Southeast Asian countries and the NICs in recent years, not able to export to Japan, have exported to the United States. This causes a large distortion in trade flows between the United States and East Asia. Thank you.

Mr. AHEARN. Thank you, Roger. We turn now to our next commentator Marcus Noland. Mr. Noland is a Research Associate at the Institute for International Economics. He was educated at Swarthmore College and the Johns Hopkins University. He has published a number of articles relating to Asian trade and is currently completing a book with Professor Bela Balassa of Johns Hopkins on the Japanese economy. Dr. Noland has also worked at the Federal Reserve Board in the research department. Dr. Noland, please.

**STATEMENT OF MARCUS NOLAND, RESEARCH ASSOCIATE,
INSTITUTE FOR INTERNATIONAL ECONOMICS**

Mr. NOLAND. I have a one-page handout I would like to distribute.

Mr. AHEARN. The handout will be inserted in the record.
[The handout follows:]

Purchasing Power Adjusted Per Capita Incomes

1985		2000, projected	
Singapore	9447	Singapore	15831
Hong Kong	9093	Hong Kong	14799
Austria	8929	Austria	11661
Italy	7425	Italy	10283
Spain	6437	Spain	6319
Greece	4464	Taiwan	5739
Portugal	3729	Greece	5470
Taiwan	3581	Malaysia	5334
Malaysia	3415	Korea	4913
Korea	3056	Portugal	4329
Turkey	2533	Turkey	3481
Thailand	1900	Thailand	2647
Philippines	1361	Philippines	1029

Data source: Robert Summers and Alan Heston, "A New Set of International Comparisons of Real Product and Prices Levels Estimates for 130 Countries, 1950-1985."
Projections based on period 1960-1985.

Noland, 6-29-88.

Geographical Composition of Exports, 1986
(percentage of total exports)

<u>Exporter</u>	<u>Destination</u>		
	United States	Japan	Pacific Basin Developing Countries
China	8.4	15.1	37.2
Hong Kong	31.4	4.7	32.9
Korea	38.5	15.2	9.5
Indonesia	19.6	44.8	17.2
Malaysia	16.6	22.5	33.4
Philippines	35.7	17.8	18.8
Singapore	23.4	11.7	32.3
Taiwan	47.7	11.4	13.6
Thailand	17.9	14.1	25.7

Data Sources: IMF, Direction of Trade, 1987; Board of Foreign Trade, Ministry of Economic Affairs, Foreign Trade and Development of the Republic of China, 1987.

Mr. NOLAND. Well, I'd like to say that I think that Randy Jones' paper is a very excellent one. He does a good job of surveying a wide range of issues having to do with the emergence of East Asian economies. And as such, I have no strong disagreements with the paper. Any disagreements would basically be frivolous, so what I would like to do is elaborate on some of the points that he touched on briefly.

The central message of his paper is that the East Asian economic performance has been outstanding in the recent past. And I think that could be underscored by looking at the top half of the handout which shows purchasing power adjusted per capita incomes for some Asian countries and for some European countries for 1985. These purchasing power adjusted figures are adjusted for differences in relative prices of traded and nontraded goods across different economies. In particular, some nontraded goods, such as housing and personal services, tend to be cheaper in countries with lower levels of income. Consequently, national income comparisons expressed in terms of a common currency market exchange rates such as the ones that appear in Randy's paper tend to be somewhat misleading—for instance by generating too large a dispersion of incomes.

I think the central message of my hand-out, if you look at the first numbers in the column for 1985, is that the city states of Singapore and Hong Kong have adjusted per capita incomes that are as high as the poorer countries of western Europe. Following them there is a bloc of countries consisting of Southern Europe, and then there's the rest of Asia. Now, what I did was I took the past 25 years of data on per capita income and simply projected it into the future. These projections should be taken with a large grain of salt. They are not necessarily what I think is going to happen. But if you simply took historical trends and projected it forward 15 years, you would get what appears in the second column. And as you can see, because of differential rates of growth of per capita incomes, the development of the Asian countries is quite astounding. The two city-states extend their leads over Austria and Italy. But I think more interestingly, the Gang of Four plus Malaysia all by the year 2000 would have higher per capita incomes than Greece has today. And in the year 2000 Taiwan would exceed Greece and be closing in on Spain. And Malaysia and Korea would exceed per capita incomes in Portugal.

All this is to say that I think in general when we talk about Asia, we tend to have outmoded notions about what those countries' economies are like. We tend to regard them as developing countries. These figures tend to undermine that notion, and undermine our notions of having a sort of a strict bifurcation between developed and developing countries. Per capita levels of income and standards of living in these countries are high. They're growing rapidly and if they continue growing at that rate in the future, by the year 2000 East Asia will essentially look like Europe—with Japan at the top having per capita income and technological capacity on par with the United States or the most developed countries of Western Europe, and the other countries of Asia quickly moving up on the poorer countries in Western Europe.

Having laid out that rosy scenario, what do I think would impinge on it being realized? I would emphasize four factors. The first is that many of the countries in East Asia face political threats, either internally or externally, which could flare up in the future, and undermine the stability of those regimes and the performance of the economy.

The second thing I would point to would be what I would call international market uncertainties. And the first big question mark here is the United States. Many of these countries rely heavily on the United States market as the bottom half of that handout, which is the geographical distributions of exports, shows. These countries have largely developed in the context of having basically open international markets, in particular, a large and fairly open U.S. market, and it is not at all clear that that's going to continue into the future. For one thing, there are explicit moves towards protection within the United States. But if the protectionists don't get these countries, just more fundamental balance of payments things may. If you believe that the United States' current account is unsustainable at its current level, and that the current account deficit has to be reduced to say anything from zero to a deficit of \$50 billion, a reduction in the merchandise trade deficit of \$150-\$200 billion will be required. It will take \$150 billion to eliminate the trade deficit, plus another \$50 billion to service the rapidly increasing stock of foreign debt. Moreover, there are adverse terms of trade effects as the dollar depreciates. It means that in volume terms, you're talking about a potential swing of the trade balance of \$200-\$250 billion if you want to get the U.S. current account to about zero. That's a big number. And some of that is undoubtedly going to come out of the surpluses that Asia runs, because at the end of the day, the world's current account balances must add up to zero. If the U.S. is going to get rid of a \$250 billion deficit, then other people have to reduce their surpluses or increase their deficits by the same amount.

The second big question mark I think is Japan. As shown in my hand-out, Japan has not been as important a market, especially in terms of manufactured exports for East Asian countries. Recently the volume of manufactured imports into Japan from these countries has been rising. Whether this is sustained and how far it will eventually go, I think, is still pretty much an open question. I think that direct foreign investment in the Asian countries will contribute to an increase in manufactured imports as Japanese subsidiaries reexport back to Japan. Likewise I think that Japan, on the financial side, will be increasingly important to these countries. First, Japanese financial institutions are large. They control a lot of investment, and they're putting a lot of investment into these countries. Second, Japanese official lending is increasing at a much more rapid rate than the United States, and much of that is earmarked for the countries of East Asia. But since most of that official lending is in fact loans denominated in yen, what I think is going to happen is there is going to be a continuing need for these countries to export to Japan to earn yen export receipts, and the yen will tend to start replacing the dollar as the reserve currency that they hold.

The third thing that may impinge on the future rates of development, I think, of these countries is a lack of policy coordination among themselves. I'm struck by how little the countries of East Asia seem to coordinate amongst themselves. An example I would cite is the exchange policies of East Asian NIC's. It appears to me that one could make a pretty good argument that it would be in the self-interest of say, Taiwan, to appreciate the new Taiwan (at least or it would have been a couple of years ago), and likewise for these other countries. But they all resist doing so because I think they're in a classic prisoner's dilemma situation—nobody wants to move first and allow their currency to appreciate because they fear losing their export markets to the other three. It seems to me that one could make a good case that the four little Tigers should coordinate their exchange rate policies so they could jointly appreciate, jointly upgrade their exports, and get out of this kind of prisoner's dilemma situation. But when I talk to policymakers in these countries, they express absolutely no ability or interest in coordinating with their counterparts in the other countries. They simply want to come to Washington and talk to the U.S. on a bilateral basis. And so I think that in the future, greater policy coordination among the East Asian countries could benefit their economic development.

Finally, the fourth question is China. China is a real wild card here. If the Chinese were successful in their economic reforms (a likelihood I remain very skeptical of), and really move to a greater external orientation quickly, that could have very big ramifications for the other countries in East Asia. For some of the less developed countries in East Asia, such as Thailand and Malaysia, and more generally, moving west, the countries of Central Asia, these could be bad. The NICs were able to develop in a context where there was not that much competition from other developing countries in international markets for the goods they were producing. If China really goes into international markets in a big way, some of the less developed countries in East Asia could really get squeezed. On the other hand, greater market opening by China, I think, represents a very big opportunity for the NIC's. There's already a fair amount of trade and investment between China and Korea, and if political problems were settled in certain ways, the same would hold true for China and Taiwan. You could see those countries doing a lot of technological transfer, a lot of investment, and a lot of joint ventures in China. So if China's economic reforms are successful, I think it represents a threat for some of the countries, but a great opportunity for the others.

Mr. AHEARN. Thank you, Marcus. We will open up the discussion now for questions and comments beginning with John Bennett of the Korea Economic Institute.

Mr. BENNETT. I will comment on the speaker's emphasis on the adjustment problem that Asia and the U.S. face with respect to each other. I think there is a market-opening issue with many Asian countries, but when we talk about that, we are talking about an increased efficiency argument, and this is really a secondary or tertiary problem, which we can handle over a long period of time. But it's not going to solve the major adjustment problems implicit in the U.S. trade deficit and these other countries' enormous trade

surpluses. That is going to be the major problem over the next 5 or 10 years. It's the one that can work out badly for everybody including the U.S. And it's the one I think this conference should be focusing on. It's the one that the Institute for International Economics has been talking about for some time.

It is impressive though—the absolute total unmoving resistance—from every country in this area, each saying why it shouldn't do something about its exchange rates. On the other hand, it takes two to adjust. The Koreans and the Taiwanese aren't going to stop exporting to the United States until the U.S. makes it unattractive for them to export. And we have it within our power, and it's essential that we do. But as long as we have a Congress that won't cut expenditures and an administration that won't increase taxes, we have an enormous budget deficit which continues to be reflected in net capital inflows and a trade deficit. At some point clearly this won't be able to continue. And it will be extremely important that we make the adjustments without causing a depression.

In looking at Korea's trade with the region—if they are not to get growth in the United States, where else can they get it? I don't think Europe is very interesting for them. It also tends to be closed and highly competitive within itself. But if you go back and look at the data for some years, non-Japan—Asia was Korea's second largest market, and I suspect if you start looking at the trade patterns of the others that you will find the same thing, and that's really where the Koreans have to look for their growth. And where the Taiwanese have to look for their growth—all the countries in this area. That is a solution for them. The question is whether it will grow fast enough to continue to fuel the growth that has occurred in the NICs in all of the area.

I think the PRC is going to be the most difficult country to absorb into the global trading system. I look at Korea; I look at the PRC. Up to 1986 they've always imported more than they have exported, as long as somebody will lend the money. Korea has only changed now—this is the third year in which it will have a trade surplus. So that's a significant change for them. Following the Korean experience, the PRC and some of the other countries in the area will be able to accept trade deficits if they go into productive facilities.

One other thing that strikes me that really gets ignored in the discussion of trade is technology and the importance that technology has played in the growth of these countries. The fact is that most of them—Japan first, then the NICs, and now several other countries are able to play catch up technologically speaking. They're going from very low levels of technology to middle levels of technology. That new technology they have been able to get either free or very cheaply, and although you can find example after example, where they have had problems getting their technology, it hasn't really slowed their growth. Korea last year hit 12 percent growth; first quarter this year, it was 15 percent. You can't grow much faster than that. They're absorbing technology at a very rapid rate in order to do that, and yet, there is still much better technology they can adopt.

Now the exchange rate. We usually use nominal GNP per capita—I assume this was what Marcus Noland was using in the table here—per capita GNP adjusted for inflation. Am I correct? Or are these really national incomes? You got your table—purchasing power adjusted per capita income. It's national income. I just want to challenge you on one point. I was looking at this the other day in the Korean case, and per capita GNP in 1987 was \$2800. Per capita private consumption was \$1,700. Think about that! You're not talking about rich countries. You're not talking about developed countries. I think you have to take that aspect in account.

Mr. AHEARN. Thank you John for those observations. Other comments or questions? Kent Calder?

Mr. CALDER. I have a question which was posed by something that Roger Severance mentioned. It relates to the shift southward of the American deficit as new Japanese export platforms begin to arise in various nations of ASEAN. Roger mentioned that this would create new deficits with the United States that would perhaps supplant some of the ones in Northeast Asia that may be gradually declining because of yen reevaluation and so on.

My question has two parts. The first is whether the deficits necessarily would be with the United States? In the short run, which I suspect was the time frame you were talking about, I think it is inevitable. In the longer run, to what extent can Japan really supplant those? And the related question—I suppose this is provoked by some of Marcus Noland's comments and Randy Jones' as well—was if in fact Japan does begin to supplant the United States as the growth market at the margin, what are the broader implications in terms of influence for the two nations will this new market access the Japanese provide give them as opposed to the United States?

Mr. SEVERANCE. With respect to your second point, I think if you believe that Japan is going to open up its market, naturally their influence would increase. I happen to believe that it is going to be a long time before Japan truly opens its market to imported products. I think that the investment shifts southward will be primarily Japanese investment in Southeast Asia—although to some extent U.S. investment, particularly U.S. electronics investment in Taiwan, is being transferred to Thailand and Malaysia. And so, in part, that will exacerbate the trade surplus with the United States on the part of Malaysia and Thailand.

Mr. AHEARN. Ralph Clough?

Mr. CLOUGH. I'd like to underline the comment on China, that China is indeed a wild card in the deck. It's very difficult to predict what is going to happen. One of the uncertainties involves the future of Hong Kong, because anyone who has been recently in Guangdong Province, as I have, will be aware of the tremendous flow of Hong Kong money into Guangdong which has created a real economic boom there. How long will this continue? What will happen after 1997? In currently debating the basic law and how the government of Hong Kong would be formed after 1997, people are asking how much influence Beijing will have? All of these matters are very uncertain and the result has been, of course, the emigration of quite a large number of middle-management and wealthy people to other parts of the world—people who don't want

to take the risk that post-1997 would be difficult for them. I just wanted to stress the future of Hong Kong as another uncertainty before the year 2000.

Mr. AHEARN. Bill Barnds from the Japan Economic Institute has his hand up and then Ira Wolf. Mr. Barnds?

Mr. BARND. I would like to make two points. The first is when we talk about per capita incomes and standards of living, I think we have to separate those two out. A country's standard of living depends a lot on the capital stock, particularly in housing, that is in place. A lot of the countries that are growing very fast may have per capita incomes comparable to some of the European countries, but I think their standard of living is still somewhat behind.

The second and much more interesting point, I think, is something we'll be returning to during the course of the day. This has to do with United States influence as it becomes less the key market for a lot of these countries. In one sense, that's going to reduce U.S. influence because countries that have sold so much here have felt that they would have to accommodate us at least on a lot of issues if we really pressed. At the same time, their estimate of the United States economic future is rather pessimistic and I think this has some impact on our influence relative to say that of Japan. If we turn around our trade deficit situation and get our own house in order, we may not be importing as much or we may be exporting a whole lot more—I think it'll be a mixture of the two—to these countries, but we will be in a much stronger international economic position generally. And how those two factors will cut against each other in terms of American influence is going to be a very tricky thing to evaluate.

Mr. AHEARN. Ira Wolf?

Mr. WOLF. Three quick points. One, this workshop has the wrong title. We aren't talking about East Asia. We're talking about Japan or about the triangular relationship among the rest of East Asia, the United States, and Japan. Japan is in Asia but not of Asia. The United States is not in Asia but is more of Asia than is Japan. What is the degree to which Japan is becoming of Asia? Clearly, it is on the increase. Is it yet as much of Asia as the United States? I think it's still got a long way to go, even in the economic sphere, not to speak of the political and security.

Two—so far in the first hour I only heard the word "protectionism" used once. I just want to throw my marker down, as I do everytime I'm in a meeting like this. Protectionism should be defined as the closing of a market or a part of a market for purely local, greedy, self-serving reasons. Protectionism, if it is defined as closing a market for tactical negotiating reasons or strategic, and I hesitate to use this word—strategic industrial policy—is not necessarily bad. I think we should maintain the first very narrow definition of protectionism. I'll raise this again whenever someone uses that nasty word.

Third—to put a little meat on the China issue—it's interesting to look at textiles in the Multifiber Arrangement—the MFA. Economic restructuring in China has succeeded dramatically in textiles. If you take off the MFA tomorrow, the American market and, perhaps, most markets around the world for textiles—not just at the low end for textiles and apparel, but at the middle and, ultimately

at the high end—will be utterly dominated by the Chinese. No one in the world can come even close to competing with the Chinese on textiles. The MFA is not going to disappear tomorrow, but should it happen, the result would be a dramatic effect on Korea, on Taiwan, on the NIC's, and all sorts of LDCs. Again, it's an example of where China has truly succeeded and is being constrained simply by this artificial mechanism.

Mr. AHEARN. Erland Heginbotham from the U.S. International Trade Commission is next.

Mr. HEGINBOTHAM. I think that to focus overly on the notion of threats from East Asia is incorrect, but I found the general tenor of the discussion seems to be somewhat unduly optimistic and benign this morning. For one thing, I think that the notion that East Asia is not a bloc, does not coordinate or have the same policies,—in fact, misses the basic point, which is that East Asia has complementarities amongst the economies not found in any other region of the world. The growing intensity of complementary and mutually supporting relationships in spite of diversities in objectives, economic structure, and national policies is in fact what gives the region its dynamism.

Perhaps better than to call East Asia a threat is to say that it has created an economic challenge of a sort that the nations of the world have never seen before. The challenge of trying to adjust to the dynamism, the rapidity of change in East Asia is gigantic. So perhaps the greater question is whether the United States is up to the challenge of adjusting to the challenge of East Asia. And this reminds me of the words of the immortal Chinese sage Pogo—we have met the enemy and he is us. And we should look not just at the trade gap. At some exchange rate, we can balance our trade. The real issues are standard of living, command over resources, and terms of trade.

If you look at the discrepancies in the more fundamental economic comparisons between the U.S. and East Asia, some of which have been cited here this morning, the discrepancies are great. John Bennett mentioned the discrepancy between consumption and income in Korea. Look at the savings investment ratio in the United States, and the preemption by government of what pathetic savings we have for expenditures that have nothing to do with productivity or economic effectiveness; look at the short-term orientation of U.S. industry, and at the lack of U.S. industrial strategies, and at export controls which afflict our most productive and most competitive industries. It's hard to see, given the challenges from East Asia, how it can be anything but downhill for the United States unless we make some massive changes at home. It is true that there are reluctances on the part of East Asia to adjust, but when you're running from behind and you're not determining the thrust of world developments, the fact that they're not adjusting is less a problem for us than the fact that we're not adjusting.

Mr. AHEARN. On that optimistic note, unless any of our panelists have a comment they would like to make—Randy?

Mr. JONES. Yes, I agree that East Asia poses a challenge to the United States. If we view East Asia as a threat, though, it suggests that we should try to shut it out or close our doors. If we look at it as a challenge, perhaps it can motivate us to do better. Japan

spends a larger share of its GNP on research and development than we do. If one excludes the military R&D, the gap is quite large. If one compares investment as a share of GNP during the past 20 years, it is 32 percent in Japan and only 18 percent in the United States. It's up to the United States to meet this challenge and to take advantage of the opportunities presented by East Asia.

Mr. AHEARN. Thank you very much, Randy, Roger, and Marcus. We're going to shuffle seats right now and move on to the second panel. Anyone who wants to get a cup of coffee or tea, feel free to do so, but please don't do it all at once.

PANEL 2.—EAST ASIA AS A REGIONAL TRADING BLOC

DISCUSSION LEADER: Edward J. Lincoln, Senior Fellow, the Brookings Institution, Washington, D.C.

COMMENTATORS:

Thomas Fingar, Chief, China Division, Bureau of Intelligence and Research, U.S. Department of State

Frederick Z. Brown, Senior Associate, Carnegie Endowment for International Peace, Washington, D.C.

MODERATOR: Raymond J. Ahearn, Specialist in Asian Affairs, Congressional Research Service

Mr. AHEARN. We'll be covering some of the same issues in this panel with a slightly different focus. We're delighted to have Ed Lincoln here today to serve as our discussion leader on the topic of East Asia as a Regional Trading Bloc. Mr. Lincoln is a Senior Fellow in the Foreign Policy Studies Program at the Brookings Institution, specializing in international economics and the Japanese economy. He has just completed a study of macroeconomic changes in Japan over the past decade and their impact on the bilateral relationship. This book was published in December 1987 under the title *Japan: Facing Economic Maturity*. Dr. Lincoln also teaches at the Johns Hopkins University School of Advanced International Studies.

Dr. Lincoln, please.

STATEMENT OF EDWARD J. LINCOLN, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. LINCOLN. I think there's some danger here of repeating previous points so I'll pass over some areas fairly quickly.

The topic is Asia as a regional trading bloc. We can start with the data. There is a substantial amount of trade within this part of the world, especially when the United States is included as part of the region. My paper also includes the Soviet Union in the region, not that it makes much difference, because trade ties with the Soviet Union are very small. But defining the region broadly in this way, roughly 50 percent of the merchandise trade is within the region, and for some countries the level is as high as 60 or 70 percent. Much of that trade has been centered on the United States and Japan, which are the two key trading partners for virtually every country in the region. So if the United States and Japan are excluded, then the share of intraregional trade drops by half to about 24-25 percent. Thus, the picture is one of very strong ties with Japan and the United States, and substantial, but much weaker, ties among the other countries of the region.

Intraregional trade has also been growing over time—an evolutionary change. The share of intraregional trade has roughly doubled from about 25 percent up to the 50 percent level over the past 20 years.

The same basic facts hold for investment. Japan and the United States dominate most investment relationships around the region. The exceptions are two close geographical pairs—Singapore-Malaysia, and Hong Kong-China, which have very strong bilateral investment ties. But otherwise, Japan and the United States have the largest amounts of direct investment in countries around the region.

Often we think of Japan as a special relationship with Asia because it's an Asian country with some cultural similarities with other countries in the region. And yet in no sense does Japan seem to have dominated the economic ties. The United States—farther away and with little cultural commonality with the region—has done very well. Furthermore, over the past 15 years, Japan has not replaced the United States. For example, the share of imports from Japan in the total imports of Asian countries increased, but so has the share of their imports from the United States. The share coming from Japan has risen dramatically; the share from the United States has increased by only a minor amount. The implication is that we have not been hurt by Japan; it is the other countries around the world that have been tossed out of Asian markets. Together the United States and Japan have come to dominate more than we have in the past.

Despite the substantial and growing economic ties that seem to take place in this region, there do not exist any formal regional organizations focused on economic issues—or any preferential trading arrangements in Asia. ASEAN is a subregional organization, and has done more to address political questions than economic questions. The only formal (with a physical plant and centralized permanent secretariat) or official organizations (established by governments at which government officials participate in their official capacities) we do have are the Asian Development Bank and ESCAP. They are regional organizations, not because of any upsurge of regional interest, but simply because they are convenient geographical subdivisions of global multilateral organizations—the United Nations and the World Bank. Beyond that, the existing organizations are very informal. PBECC—Pacific Basin Economic Cooperation Council—which is mostly an organization of businessmen. PAFTAD—the Pacific Trade and Development Conference series—is mainly an academic meeting which takes place once a year. PECC—the Pacific Economic Cooperation Conference—has meetings to which government officials can go, but in their unofficial capacities. PECC may be the most well-established in that it has secretariats in individual countries, but there is no central office.

Why isn't there a stronger organization? Randy Jones pointed out the economic diversity of the region as something which has impeded this process. That's quite true. Diversity decreases the scope of common interests. In fact, one of the remarkable things is what Marcus Noland pointed out—the countries do have a common interest in the region don't get together. Generally, the things that

the United States and Japan would want or are interested in discussing in a regional setting are widely different from what developing countries want.

There's also a diversity in absolute size. That has been very important over the past 20 years. These countries are afraid of being pulled into an organization that is proposed and sponsored by Japan or the United States, and fear that because of the overwhelming size of Japan and the United States, we will dominate. Because we do not have many common interests, we will dominate the agenda in a direction the developing countries do not want.

Then there are some special problems with Japan. Increasingly, Asian countries think of special problems of the United States as well, but Japan has such a reputation as being protectionist—whether in Ira Wolf's narrow definition or in a broader industrial policy definition—Japan has been very protectionist and mercantilist in its foreign policy. Foreign aid, for example, has been rather closely tied to Japanese commercial interests rather than to the development interests of the recipient countries. More broadly, its trade relations have been pushed in a direction very clearly to benefit Japan—motivated either by Japan's sense of natural resource dependence or its fear of developing countries moving into manufactured product areas that it has occupied.

Finally there are some very serious political divisions that in the past have been a serious obstacle to any kind of broad regional organization. Only within the last year or two has there been substantial movement on the problem of what to in a regional organization with China and Taiwan. Which one will belong? One of my big complaints is the fact that by having thrown Taiwan out of the IMF, we no longer get any statistical data on Taiwan. This is unfair, by the way, because in the past when Taiwan was in and China was out, the IMF published data on China. Now Taiwan has completely disappeared. These political problems may be somewhat less serious now, so that if there were a regional organization, participation by both China and Taiwan could be worked out on some acceptable grounds.

The Soviet Union is the other problem. They too are showing increasing interest in participating in organizations like PECC, but in many ways they are isolated from the rest of the region. Trade has been at a rather low level. Their allies in the region—North Korea and Viet Nam—are the other two countries that do not really participate. In fact, I notice Randy Jones did not mention them either. There is no data whatsoever on those countries because they do not participate in any international organizations. So there is a problem of political divisions.

Now let us turn to the changes that are taking place, with a focus on the macroeconomic changes that have taken place in the 1980s. The United States pushed itself into enormous deficits and Japan to surpluses. For a period of time, this made the United States a great engine of growth for other Asian countries, giving them very rapid export growth to the United States. Now this situation is likely to be sharply reversed. As the U.S. current account deficit stabilizes and begins to fall (assuming that we make some progress on changing macroeconomic policy in the United States), and as the Japanese current account surplus begins to fall, the

next 5 to 10 years may produce an environment in which U.S. imports from Asia will expand very slowly at most, and could possibly even start to fall, whereas Japan's imports could rise very quickly. The Japanese will tell you that imports are rising very quickly, but Marcus Noland has pointed out quite rightly that this is true only of dollar figures. The rise in the yen figures for imports is not very dramatic. This effect is due to exchange rate movements.

However, there is a psychological change in Japan. Industry and households speak of imports from Asia differently than they used to 3 or 4 years ago; the Japanese have become much more accepting of imports. I remember talking to people from Hyundai Motors just 3 years ago, as they were about to start exporting cars to the United States. When asked about their plans to export to Japan? And they laughed in my face and said, "export to Japan? Are you crazy? They would never buy a car from us." They are exporting to Japan now. So there is a degree of psychological acceptance of manufactured imports from Asia.

In many cases, the imports will be from Japanese subsidiaries. In fact, this is the way imports from Hyundai are being billed because the technology came from Mitsubishi Motors. But I don't care how it happens. The important point is the change in attitudes. It used to be the case, by the way, that when the Japanese built factories abroad, they were not for the purposes of exporting products back to Japan. Now they are in some cases, a change which is also part of the psychological shift.

Reinforcing the shift, Marcus has mentioned that the yen is likely to become more important as a reserve currency throughout the region and that Japanese direct investment in these countries is rising very rapidly. My understanding is that this investment does not seem to be arousing the kind of anti-Japanese opposition that it did back in the early 1970s. Investment may continue unimpeded for some time. Meanwhile, the United States is likely to continue a posture of hectoring the rest of the region about import barriers. Most of these countries have protectionist policies, and if the United States intends to expand its exports—we will be trying to reduce the barriers to those exports in Asian countries.

The result of all this is that the image we have of ourselves as being the good guys in Asia and the Japanese the bad guys may change very substantially. As that happens, there is the possibility, (though not necessarily a high probability at the moment), of Japan taking the lead in putting together a regional organization or a regional trading arrangement that excludes the United States. Japan is now certainly very heavily pushing the idea of some kind of regional organization, although the talk is primarily of something that includes the United States. For example, they have been proposing that PECC be turned into an Asian OECD. But there are others in the Japanese government who have been speaking, at least quietly, about a trade zone that does not include the United States. Japan and Taiwan are also pressing the United States for bilateral trade arrangements patterned on the U.S.-Canadian deal, and if those don't go through (and I doubt very much that they will), there is the possibility that Japan might turn to other Asian countries for such arrangements.

A regional trade zone with or without the United States is not particularly desirable for several reasons. First, One, all regional trade zones have two aspects—trade creation and trade diversion. We create trade by getting rid of barriers. But we also divert trade and we can divert trade in inefficient ways. You buy something from a partner within the trading zone because the price appears to be cheaper. But the partner may not be the efficient producer. The price may look cheaper because no tariff is involved, whereas there is a tariff for any product from outside the region.

Second, the United States needs open markets abroad for U.S. goods, and if the region moves toward a trading arrangement that does not include the United States, we are the ones who would find trade being diverted away from us. We certainly don't want that happening.

Third and the most serious, any kind of arrangement that does not include the United States would be manipulated by Japan in such a way as to lower the regional economic involvement of the United States. Even if Japan is becoming more internationalist and less protectionist, I still feel very strongly that this is the direction that Japan would push such an organization.

The United States should press very strongly in the next administration for a successful conclusion of the Uruguay Round of multilateral trade talks. If our national interest is not in a regional relationship, then let's push very hard on the global multilateral arrangement. Furthermore, if we do need an organization, we should press harder for bringing the Asian NIC's into the OECD. This is an idea that I have tried out several times and it has been greeted by laughter. But I might point out that the OECD is not an organization of advanced industrial countries. It began as an organization of countries that were involved in the Marshall Plan, and Marcus Noland's chart shows the purchasing power levels of income in different countries is very instructive. There are Asian countries above the income levels of some of the participants in the OECD. There is no particular reason why they do not belong in the OECD. There is a further problem that Taiwan and Hong Kong are NIC's. They too belong in the OECD, and I would point out that the OECD charter does not use the word "nation" or "country." It uses the word "governments," which is infinitely flexible. Hong Kong and Taiwan are certainly governments, and even the Chinese would admit that. So if it was acceptable to the members of the OECD, entry by Hong Kong and Taiwan could be managed. The Europeans are not particularly interested in this idea and, oddly enough, the Japanese are not interested in this idea, which is something that surprises me and reinforces my feeling that the Japanese want to push a regional organization. Because that is their agenda, they don't want to talk about expanding the OECD.

Mr. AHEARN. Thank you, Ed. Your prepared statement will be inserted in the record.

[The prepared statement follows:]

PREPARED STATEMENT OF EDWARD J. LINCOLN, SENIOR FELLOW, THE BROOKINGS
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EAST ASIA AS A REGIONAL TRADING BLOC

Introduction

The American assumption that East Asia or the Pacific Basin is an important concept lies in the belief that regional economic ties are close and becoming increasingly so. Interest in the region has prompted many calls over the past two decades for creation of new international organizations to address the needs and problems of the region. As an Asian specialist, all of this attention and interest is quite gratifying. As an economist, though, one is prompted to ask some questions about the actual nature of the economic relationships in Asia and what they imply for broader regional issues. The economic ties among nations in the region are indeed thickening, but preferential trading arrangements or other institutional arrangements within the region are not necessarily in the national interest of the United States, for reasons that will be sketched out below.

One of the striking features of this region,¹ in fact, is the lack of regional economic organizations or arrangements encompassing all or most of the nations in the region. ASEAN has emerged as a formal political structure, but it is a sub-regional organization, and has not moved very far in removing intra-group trade barriers. Other regional organizations abound, but they are quite informal; nothing to lower trade barriers, promote investment flows, or even publish data and promote policy coordination (i.e., similar to the OECD) exists on a regional basis. This paper explores the trade and investment relationships within the region and offers some thoughts on why the regional institutional framework is so thin.

A second striking feature of this region is that it now faces important shifts in trade and investment relationships precipitated by the enormous macroeconomic imbalances of the United States and Japan in the first half of the 1980s and the correction of those imbalances that is now beginning to occur. A central question is to what extent these forces will push the region, or parts thereof, toward integration? This question is especially important as the world faces the Uruguay round of GATT negotiations amidst fears of failure and a move toward bilateral or regional arrangements in its wake. A case can be made that pressure will build for a preferential trade and investment area centered on Japan (and possibly exclusive of the United States), a development that would not be in the national interest of the United States.

Regional International Trade Ties

A key measure of regional integration is the share of trade that takes place within the region. Do countries in East Asia engage in a great deal of trade with one another? Or do they trade mostly with other nations outside the region? Data on these questions are presented in Table 1, and suggest a rising importance of regional trade.

For all the countries on the list, the share of exports destined to other nations in the region was 48 percent in 1986, a very large gain of 27 percentage points over the previous 20 years. The share of exports from most individual countries in the region destined to others in the region is quite high—over 60 percent for all but a few. Only the Soviet Union and Canada have low involvement in regional trade, and for neither country has their involvement been increasing.²

For many of the nations in the region, the share of exports has risen substantially over time—and the gain has been especially high for New Zealand and Indonesia.

The regional economy is dominated by the United States and Japan, so that much of the rising importance of regional trade could be accounted for by these two nations. The rapid economic growth of Japan, in particular, could be responsible for much of the increase. Therefore, Table 1 also shows trade for a subset of the region—all nations except Japan, the United States, and Canada. As might be expected, the share of exports within the subset is much lower (24 percent in 1986), and the growth over time is generally lower as well (up 9 percentage points from

¹ Asia and the Pacific Basin are vague geographical concepts. For purposes of this paper, the region under consideration consists of the United States, Japan, the Soviet Union, China, the Asia NICs, and the ASEAN countries. Mongolia, North Korea, and Vietnam could be included as well, but Mongolia is a continental country with little economic connection beyond the Soviet Union, and both North Korea and Vietnam remain quite isolated politically and economically.

² For purposes of defining trade within the region, bilateral trade between Canada and the United States, as well as the Soviet Union and the United States (and with Canada) are excluded from these calculations, since these flows cannot be labeled properly as regional trade.

1966). China and Hong Kong show a high dependency on exports to this subregion, but largely due to Hong Kong's role as an import/export center for China.³

The picture presented by these data is mixed. The region is clearly an important and growing part of the trading patterns of most its nations. However, much of the importance is due to the presence of Japan and the United States. A glance on the original data (included as an appendix to this paper) amply demonstrates that these two countries far outweigh any of the other bilateral ties (with the exception of the China/Hong Kong relationship). Only when trade with all of the other countries in the region are added together does the total even begin to approach exports to Japan and the United States.

Similarly, the pattern of relationships with Japan and the United States are mixed. In 1986, the countries in the subset sent 24 percent of their exports to the United States (a substantial gain from 14 percent in 1966), while only 14 percent went to Japan (down 3 percentage points over the same time period). The downward shift for Japan is due primarily to the diversification of trade by Taiwan and South Korea, both of which were colonies before the war and remained highly dependent on Japan as an export market for a time after the war. On the import side, the picture is reversed: the share of imports coming to these countries from Japan was 37 percent in 1986, up a substantial 17 percentage points over 1966, while the share from the United States was a smaller 19 percent, up only 3 percentage points. However, in no sense of the term has Japan "replaced" the United States as an economic partner with other Asian countries; even though Japan's share in their imports is roughly double that of the United States, Japan rising share has come at the expense of nations other than the United States (since the U.S. share also rose). A more correct interpretation would be that both Japan and the United States have come to dominate the trade of these nations to a greater degree than in the past.

Probably the largest structural change in regional trading patterns has been the emergence of China from its relative exclusion of the earlier postwar period. But even this change is evident primarily from a U.S. perspective since there was no U.S.-China trade at all in 1966. From a broader perspective, the growth of Chinese exports to the rest of the region does not outpace other nations. China's exports to the other countries on this list grew at an annual average rate of 18 percent over the 20 year period to 1986? While this is a rather high growth rate, it is overshadowed by the performance of others: Taiwan's exports to the region grew at a 25 percent annual pace, while those of South Korea soared by an even higher 27 percent. As a structural change, China's trade with the United States and others has been an important development, but it was not isolated from some of the other countries in the region even in 1966 and overall its economic growth and export growth has been lower.

Regional Investment Ties

Data on investment ties are less well developed than those on merchandise trade, and the numbers provided by one country are often calculated on a different basis from those of others. Nevertheless, at least a few comments follow from available data.

For direct investment—plant and equipment investment by foreign companies in local subsidiaries—Japan and the United States appear to dominate in the region (See Table 2). In the Asian NICs, the United States generally has the larger share (except for South Korea), while in the ASEAN countries, Japan has the larger share (except for the Philippines). Only in Malaysia are neither Japan nor the United States the largest single foreign investor, with that position held by Singapore.

In financial investment ties, Japan's role has been increasing as it has liberalized its capital markets, and as it has become a major capital exporting nation. Japanese banks are now major international actors, and foreign countries (and state-related enterprises in them) raise substantial amounts of money in Japanese and European bond markets. Among those in the region raising money in Tokyo have been Australia, New Zealand and China.

Japan's ties are stronger when capital given away—foreign aid—is added to the picture. Asia has traditionally been the center of Japan's foreign aid effort. Among the countries in Asia, China, Indonesia, South Korea, Malaysia, Thailand, and the Philippines currently receive substantial amounts of bilateral aid from Japan (and formerly both Singapore and Taiwan were on the list). Japanese bilateral aid to these countries far outweighs American aid (at least in all cases except the Philip-

³ The relatively high growth shown for Malaysia, Singapore, and Malaysia is also illusory because the IMF constructed the trade numbers for these three from the returns of other member nations, so that their mutual trade is missing from the 1966 data.

piners)—and gives aid to some countries (China and South Korea) which receive no bilateral aid at all from the United States. Furthermore, Japan dominates the Asian Development Bank, the regional multilateral lending organization. Japan dominates position in providing economic assistance for the region continues to expand rapidly, with roughly 10 percent annual increases in Japan's ODA budget in yen terms.⁴

Ideally, financial data should enable identification of the national origin of financial inflows to each of the countries of the region, permitting statements about the relative strength of financial ties and the role of the United States. No data exist to make such statements, although it is probably true that Japan and the United States are the principal financial and direct investors around the region, with a few possible exceptions (Singapore/Malaysia and China/Hong Kong). The fact that Japan is an enormous global net creditor, however, at least implies that it will continue to be a major net capital supplier in all forms to other Asian countries as well as to the rest of the world.

Status of Regional Organizations

No official, formal structures⁵ exist that tie together all or most of the nations identified as part of the region. The only major official organization is ASEAN, which includes a subset of the region. All of the organizations encompassing a broader set of countries are informal (in the sense that they have no central secretariat and do not have official government representation. These informal groups have proliferated over the past twenty years and now include the Pacific Area Trade and Development Conference (PACTAD), the Pacific Basin Economic Council (PBEC), and the Pacific Economic Cooperation Council (PECC). These groups exist mainly to share scholarly research or to reinforce the web of personal ties and information among businessmen, scholars, and government officials.

At various times, more formal or more substantive regional arrangements have been proposed, but none have materialized. Japan proposed a Pacific Free Trade Area as early as the 1960s, and in the late 1970s some attention was given to an OECD-type organization, which had the working title of Organization for Pacific Trade and Development (OPTAD). Neither of these ideas ever moved beyond the status of proposals.

Problems in Economic Integration

Why has the institutional framework for economic ties within the region been so weak? A number of factors appear to contribute to this situation: Economic Disparity. The Asian region as defined at the outset of this paper consists of a number of countries tied together principally by geography and the existence of trade ties. Economically, however, they are a very disparate lot. National income levels are difficult to compare because of movements in exchange rates, but the comparison is still useful. Table 3 provides data on per capita GNP in each of these countries. Japan, the United States, Canada, and Australia stand far ahead of all the other nations in the region. Behind them come a group of middle income developing countries, ranging from the Soviet Union, New Zealand, and Hong Kong (all close to \$7,000 per capita income level), to Taiwan and South Korea (in a lower \$2,000-\$4,000 range). Others are well below \$1,000, with China the least developed at only \$310.

Not only is there great disparity in income levels, but even the basic economic and political systems vary from one end of the spectrum to the other. The United States, Canada, Australia and Japan are large democratic nations with capitalist economic system in which the government plays a relatively restrained economic role (even though among these four the nature of that role varies considerably). Hong Kong, a small undemocratic colony scheduled to revert to Chinese rule in 1997, also prides itself on the relatively small role of the government. Taiwan and South Korea are two quasi-democratic capitalist countries with a more dominant government role in economic affairs. The Soviet Union (plus Mongolia, North Korea and Vietnam) are socialist countries with rigid systems of central planning. China on the other hand, is a socialist country now engaged in rather bold experiments that combine some elements of central planning and some features of markets and

⁴ Growth measured in dollars has been more varied because of fluctuations in the exchange rate. Over the past three years, Japan's ODA level has risen quickly because of yen appreciation against the dollar.

⁵ Official is used here to mean organizations which are created by governments and at which government officials discuss policy in their official capacities. Formal is used to mean organizations which possess permanent, full-time, centralized secretariats.

local economic autonomy (and which are much further along than the reforms now in their very early phases in the Soviet Union).

The disparity in income level and econo/political systems is so great that Asia appears to be a region in which geography is the only binding element. Certainly the region is nothing at all like Europe, where the convergence of income levels, cultural background, and political systems are much stronger. Such disparity, even in the absence of the special problems of dealing with socialist countries considered below, mitigate against a strong regional organization.

Japan.—Japan's own trade policies have been a principal obstacle to regional integration in the past. Japan is widely perceived as following very mercantilist international economic policies—obstructing the transfer of technology to developing countries, closely linking foreign aid to its other commercial interests, and maintaining stiff import barriers in product areas of interest to others in the region. Although other Asian nations have considerable respect for Japan because it is an Asian country and has reached advanced industrial status, they have been reluctant to become involved in any relationship in which Japan would have a strong voice. This is a problem that goes beyond the lingering fear of Japan that has been a legacy of the war: the problem results from observed Japanese behavior over the past 40 years since the war. One could argue that the United States is an equal obstacle simply because the smaller, poorer nations are suspicious of large, wealthy nations dominating any regional organization. This is probably true, but in discussions with Asian nations, Japan appears to have a special problem caused by its economic behavior.

China/Taiwan/South Korea.—China's increased openness to the world has been one of the major developments of the past decade, and may have led to increased perceptions of Asia as a regional economic bloc. China's emergence has not been without problems, and relations have not yet matured to the point that its presence enhances the viability of a regional organization.

The principal problem has been Taiwan and South Korea, two nations left behind in the reorientation of trade and diplomatic relations toward Beijing. While other nations have rushed to expand their trade and investment relations with China, these two were officially unable to do so. Trade and investment has actually been taking place, but on an unofficial level that places constraints on the strength of the relationships. Only in the past two years have these two countries begun to move toward more flexible positions, driven largely by the concern about being excluded as China trade expands.

Realistically, any meaningful regional organization must include all three of these countries. While the situation is in rapid flux, it is currently short of the point where their participation could be easily managed.

The Soviet Union.—The other major split within Asia is the result of the isolation of the Soviet Union and its allies (Mongolia, North Korea, and Vietnam). The economic ties are extremely thin, and face limits even as detente proceeds.

The Soviet Union has virtually isolated itself and allies from the burgeoning economies of the rest of the region, and reversal of this situation faces both political and economic obstacles. On the political side, both trade and investment is hindered by security considerations. Even if the COCOM restrictions are violated by some, they act as a constraint on trade and investment flows between the Soviet Union and others. From the perspective of the Soviet Union as well, the need for technology and manufactured goods competes with fears of being reliant on unfriendly foreign sources.

On the economic side, incentives to invest in Siberian development are lacking: raw material prices are low, supplies from other sources are more than adequate, and the terms for participation are unsatisfactory. These are problems that most directly affect Japan's interaction with the Soviet Union, since Japan is the logical market for the export of raw materials from Siberian projects. Soviet economic policy may now concentrate more heavily in industrial investment west of the Urals, but here, too, Japanese involvement has been rather limited. Some of these same problems also affect the trade picture. Two-thirds of Soviet exports to Japan, for example, are raw materials, with timber alone accounting for 26 percent. Until raw material prices rise, or until the Soviet Union can significantly increase its manufactured good exports, it faces serious problems in endeavoring to expand its trade relationships. There is no question whatsoever that the Japanese are willing to sell more to the Soviet Union (either in the form of goods, technology, or plant exports)—but only if the Soviets can pay for it.

The political and economic obstacles involved with the Soviet Union imply that its participation in any form of regional organization is unlikely to be welcomed. The situation may be somewhat more ambiguous for North Korea and Vietnam. If the

time comes when they choose to decrease their own economic isolation (which could happen only if they abandon their militaristic foreign policies) others in the region could potentially welcome them in a regional organization. Japan, for example, has always kept the door open to Vietnam and North Korea (although substantial improvement in economic relations with North Korea must be preceded by resolution of the still-outstanding financial default issue).

Coming Changes

The above explanations suggest why so little has happened to build stronger institutional ties or create preferential trade and investment zones. However, changes now taking place could push the region in this direction. These changes stem basically from recent macroeconomic developments.

During the first half of the 1980s, the United States pursued a set of domestic macroeconomic policies which led to enormous trade and current account deficits, while Japan did precisely the opposite. By the mid 1980s, the United States was the largest net debtor in the world, and Japan the largest net creditor. The U.S. move to large deficits meant that most Asian countries, including Japan, enjoyed extremely rapid growth of their exports to the United States. Export expansion contributed substantially to their overall economic growth. Meanwhile, Japan's imports from the region (especially of manufactured goods) remained relatively stagnant. Furthermore, Japan's investment in the region languished because the weak yen which accompanied these developments provided Japanese firms little incentive to expand facilities in lower-cost Asian countries.

Now the region—and the world—faces a situation in which the United States must (and will) reduce its external trade and current-account deficits. This means that imports from the region will not grow as rapidly, providing a dampening effect on economic growth in those countries. Japan, on the other hand, is moving once again in the opposite direction, reducing its enormous surpluses. In the two years from 1985 to 1987, Japan's imports from Asian countries (with the exception of raw material producers) have been rising rapidly: imports from the four Asian NICs rose 25 percent in 1986 and an even higher 44 percent in 1987, while those from China rose 31 percent in 1987. Since the base was small in some cases, rapid growth was easy to generate, but if the trend continues Asian countries will see Japan, rather than the United States, as their promising export market. The United States' in fact, will be badgering these countries more strongly about their own import barriers because of the American need to increase exports as part of its adjustment.

The nations of the region also appear to be the beneficiaries of an emerging wave of Japanese direct investment. Much of the adjustment now taking place has been generated by a reversal of exchange market conditions, with the yen very strong and the dollar weak. This gives the Japanese the incentive to invest abroad that was lacking in the first half of the decade (and the strong value of the yen lowers the cost of acquiring foreign assets. For the first time since the war, Japanese firms investing abroad are actually exporting back to Japan, whereas earlier their plants had existed almost exclusively to meet local market demand or to export to third markets.

These developments mean that Japan's image within the region will improve. Other Asian nations will see their exports to Japan rise: direct investment from Japan will increase; and they may encourage that investment if they perceive that it represents a means to generate further exports to Japan. The United States, on the other hand, will no longer be a growing market for their exports; American firms will see less incentive to invest abroad because of the cheap dollar; and American government pressure against import barriers in other nations in the region will increase. If Japan plays its cards correctly, it has the potential for improving its reputation in the region tremendously.

Foreign aid fits into this scenario as well. As noted above, the bulk of Japan's bilateral ODA goes to other Asian nations, and even though that share has slipped somewhat as Japan has expanded its horizon, Asia will remain the primary destination. Other aspects of Japan's assistance are also heavily oriented toward Asia. The principle Japanese research institute on economic development—the Institute for Developing Economies (IDCJ)—is known in Japanese as the "Asia Institute".⁶ When the Japanese think of increasing educational opportunities for people from developing countries in Japan, they think primarily of other Asians. Japanese attitudes toward other Asian countries appear to be a mixture of pride and fear: pride that

⁶ Ajiken, as IDCJ is known in Japanese, is a subsidiary of the Ministry of International Trade and Industry, and is the principal research institute working on economic development issues in Japan. Its research focus is very heavily Asian.

Asian nations are relatively free of the massive problems currently facing Latin America (revolution, debt, and drugs) or Africa (decertification, starvation, and economic stagnation), but fear that Asian countries are moving too rapidly into industries that Japan still maintains. Over the past year, casual observation of the Japanese press suggests that the balance is beginning to tilt away from fear toward acceptance and pride.

As this situation develops, the potential rises for Japan to offer a preferential Asian trading and investment zone which does not include the United States. Despite the strong liabilities which Japan has had around the region—the legacy of the war, a history of import protection, and a mercantilist foreign aid policy—the new attractiveness of Japan for the growth strategies of these nations could pull them into such an arrangement. Japan would attempt to assuage American feelings by pointing out that the European Economic Community excludes the United States as well.

Japan's interest in an Asian or Pacific preferential trade arrangement certainly appears to be on the rise. A regional trade zone was on the agenda of the Japanese national committee meeting of PECC (the Pacific Economic Cooperation Council) in the spring of 1988. Also in 1988, MITI established a task force to study the possibility of free trade zones. So far, however, Japan's discussion of this issue has not excluded the United States. Nevertheless, Japanese national pride suggests that were they to truly take the lead in some regional organization, they would not welcome an American presence. Such a move would be a major policy change for Japan, which has remained closely tied with the United States in the postwar period, and still appears quite unlikely. However, it should not be entirely ruled out.

Bilateralism

The recent U.S.-Canada agreement to establish a bilateral free trade zone has attracted great attention in Asian nations, and raises the issue of whether this approach represents a possible or reasonable route to thickening ties with Asia. Over the past year, this idea has been pressed on the United States by Japan and Taiwan. Despite some expressions of interest by influential Americans (Ambassador Mike Mansfield and Senator Robert Bryd) this approach holds little promise for several reasons:

1. The nature of trade problems with Japan are such that they could not be adequately addressed in a free trade zone. Questions of market access in Japan have dealt increasingly with non-tariff, non-quota barriers, the very existence of which is often denied by the Japanese. Therefore, the United States is unlikely to be satisfied with any definition of rules for a free trade zone proposed by Japan. Similarly, arrangements with Taiwan or others would have to address intellectual property rights and other thorny issues that these nations do not appear ready to negotiate.

2. Bilateralism would work against the trend toward strengthening regional economic ties. All bilateral arrangements increase trade by removing barriers, but they also divert trade from other nations to the preferential partner. Since many of the Asian nations compete in the same product markets, bilateral arrangements with one or several would jeopardize relations with others if the amount of trade that is diverted is substantial.

3. Some Japanese have a vision of a gradually spreading web of bilateral free trade zones ultimately coalescing into a broader regional free trade area, thus providing an alternative to frustrating and slow attempts to lower barriers through multilateral GATT negotiating rounds. Although this concept is intriguing, the reality of free trade zones is more complex: each one is different, with reservations or timetables for particular products which would enormously complicate administrative procedures. Furthermore, there would be a proliferation of separate bilateral dispute settling mechanisms (if further agreements follow the U.S.-Canada route).

4. Moves in this direction would encourage others to do the same. The United States could be substantially harmed in Japan were to begin setting up bilateral free trade zones with other Asian nations (although these would probably amount more to bilaterally managed trade zones rather free trade in the U.S.-Canadian sense). Then we would be the party suffering adversely from trade diversion.

Conclusion

East Asia, Asia, the Pacific Basin—whatever one chooses to call the region—consists of a rather odd assortment of nations with different racial or ethnic backgrounds, with different forms of government and social organization, and at wildly different levels of economic development. Perhaps it is not so surprising that stronger forms of regional institutions have failed to develop.

The existence of a gradually thickening network of economic ties among the nations of the region does not necessarily imply the desirability of new regional insti-

tutions or preferential trading arrangements. As discussed above with bilateralism, regionalism can be distorting in a purely economic sense, and such distortions are not desirable. This is especially true from an American perspective: what happens if Japan moves ahead on its own in the future, as suggested above, to create a preferential organization without American participation? Our national interest lies in maintaining relatively open markets throughout the region, and such a development would work against that goal.

Regionalism is also distorting in a political sense; why make the Europeans feel any more insecure than they are now? Even if the United States does not portray creation of new arrangements with Asia as a shift in priorities, Europeans will view such a move with great disfavor.

Organizational ties are best left at the current informal level. Thickening regional trade and investment ties are interesting and important developments, and they imply a useful role for increased opportunities for contact and exchange among government officials, academics, and businessmen. They do not imply a logical need for a stronger regional institutional framework. In fact, the thickening of ties implies that regional organizations are not needed: based on their trade orientation and rapid economic growth, the nations of the region are engaging in an informal integration without the artificial incentive of preferential arrangements.

TABLE 1

Country	Percent of its exports destined to the rest of the region		Percent of its exports destined to the subregion	
	1986	Percentage point change 1966-1986	1986	Percentage point change 1966-1986
U.S.	26	11	14	6
Japan	68	7	27	-1
Canada	8	0	4	1
USSR	10	-1	4	4
China	66	14	42	10
South Korea	68	-8	11	1
Taiwan	78	10	15	-2
Hong Kong	72	13	33	10
Singapore	68	17	36	9
Philippines	76	-2	21	16
Thailand	62	6	28	1
Indonesia	85	23	20	2
Malaysia	73	15	34	24
Australia	68	16	29	24
New Zealand	61	27	29	21
Whole Region	48	20		
Sub Region			24	9

Source: Data in appendix.

TABLE 2.—CUMULATIVE FOREIGN DIRECT INVESTMENT IN SELECTED ASIAN COUNTRIES

Recipient country	Share (percent) of investment from---			Total inward FDI (billions)	Date
	Japan	United States	ROW		
South Korea	48	30	22	\$2.0	6/84
Taiwan	30	42	29	3.3	12/84
Hong Kong	22	54	24	1.5	9/84
Singapore	20	33	47	5.0	6/83
Malaysia	18	7	75	3.4	12/83
Thailand	23	9	68	7.0	12/83
Indonesia	35	8	58	14.4	12/83
Philippines	16	52	32	2.5	12/83

Source: Bank of Japan, Monthly Report of Research Department, January 1986, cited in Yasuhiro Torii, "Recent Trend and Role of Japan in Financing Growth of Asian Countries."

TABLE 3.—PER CAPITA INCOME IN ASIAN REGION

Country	GDP per capita in 1986
United States.....	\$17,361
Japan.....	16,155
Canada.....	13,635
U.S.S.R.....	6,981
China.....	310
South Korea.....	2,361
Taiwan.....	3,995
Hong Kong.....	6,768
Singapore.....	6,698
Philippines.....	556
Thailand.....	801
Indonesia.....	451
Malaysia.....	1,725
Australia.....	9,847
New Zealand.....	6,746

Source: Data are calculated from International Monetary Fund, International Financial Statistics. Data for the Soviet Union are for 1983, from the Central Intelligence Agency, Handbook of Economic Statistics.

Mr. AHEARN. Now we turn to Tom Fingar for comments. Mr. Fingar is Chief, China Division, Bureau of Intelligence and Research, Department of State. Before assuming his current position, Mr. Fingar for many years served as a research associate at Stanford University. As a prominent China hand, we shall see whether he can solve Ed Lincoln's Taiwan data problem or get Hong Kong into the OECD. [Laughter.]

Dr. Fingar, please.

STATEMENT OF THOMAS FINGAR, CHIEF, CHINA DIVISION, BUREAU OF INTELLIGENCE AND RESEARCH, DEPARTMENT OF STATE

Mr. FINGAR. I actually do hope to come back at the end with some comments about Taiwan, but I am going to focus on a couple of issues raised in the paper. The most important relates to the lack of a formal regional structure in East Asia.

The absence of formal structures is not simply an attribute of economic interactions in the region. There is also no security structure. In the case of Europe, it is inconceivable that the OECD or COCOM would have evolved absent NATO. The fact that there is not a comparable security arrangement in Asia helps explain the lack of formal economic structures in Asia.

Should the United States worry or do anything about either the absence of formal structures, economic or otherwise, in Asia? Should the United States do anything or worry about the evolution of a Japan-centered structure? Would the other states in the region be interested in a Japan-dominated bloc? Does Asia need a leader?

The point was made in the paper about the extent to which the United States and Japan dominate the interactions of the region. Too little attention is paid to the extent to which the region's dynamism and growth is due to U.S. and Japanese policies designed to avoid big disruption. Both states have a great stake in managing their relationships so that East Asian dynamism can continue.

Japan's growth has not yet been at the expense of the United States. It has been at the expense of others in the region and you can link that to the China wild card. I've been working on China for 24 years and as long as I can remember, it's been called the wild card. There is a certain unpredictability about Chinese politics, but there's also a secular process of growing economic sophistication. I don't mean that only in terms of understanding the world, but the economy in China today is not the economy of the 1960s when abrupt policy changes did not have major repercussions. Today policy changes spill over into a whole range of things, and have a much bigger impact in China than ever before. And that's a big constraint.

China's growing involvement in the outside world is another constraint. It was relatively easy for the world to digest the four Little Tigers, although when you look at the deficit figures of the United States, you may question how well we have done in that regard. But China is a whole different game. How easy will it be to absorb the billion people of China, 160 million in the coastal areas, and the export-oriented strategy now being pursued? I'm relatively optimistic that we can, but that's predicated on an assumption that economists might find specious. Namely, I don't see how China can become a very much larger participant in the global economy without substantially opening its domestic economy to trade and investment.

There are a number of reasons for this. One is that there is a learning curve in this country based on the Japanese rolling infant-industry model of development. Much of the reticence of the business community in investing in China and transferring technology relates to demands for reciprocal market access. In today's environment, China is unlikely to succeed as an isolated export-oriented behemoth.

Very briefly on the Soviets in Asia. I think they belong in the discussion of Asia, if for no other reason than Mr. Gorbachev is determined to make them a player in other than a military way in Asia. But they don't have any cards. Their interaction in PECC is small. Asia is not interested in turning to the Soviet Union for what it needs by way of diversification, as we move in the direction indicated. And I think for a lot of other reasons, the Soviets as they do open up will be Europe-oriented.

One minor quibble with the paper has to do with COCOM in Asia. I don't think COCOM restrictions on technology have been a particular factor in what the Soviets have or haven't done so far. But it raises a different question, namely, the growing technological sophistication of the NIC's in Asia, producing items that are as sophisticated as many of those that are controlled under U.S. law or COCOM. Should there be an effort to extend the controls to these nations? That would be exceedingly difficult and probably unwise, in my judgment. Or do the controls have to be reexamined? The growth in technology indicated earlier—the speed with which it is disseminated, the level of sophistication, the rate of transition from one generation to another, has challenged the U.S.-Europe-NATO-centered approach to the world in development and the doling out of the benefits of technology to selected players.

I'll make a final comment on the degree to which the quest for market share and prosperity is driving foreign policy changes in East Asia. It does not always show up in official statistics. For example, China has no relations with South Korea. All trade is unofficial and most of it is indirect. Yet the magnitude of trade is about \$2 billion. For China the attraction of buying South Korean technology, attracting South Korean investment or in exporting to South Korea seems to be outweighing the longstanding ideological competition with the Soviet Union for influence in North Korea.

Let me return to my initial question about the desirability and the necessity for a East Asia formal organization. East Asia is very much changing in largely positive directions, where competition within the region for access to the U.S. and Japanese markets is likely to intensify. This will raise the possibility of much greater interregional political competition. There's a tremendous orientation towards a single market and it is going to be a rough adjustment for countries to begin targeting each others markets. Broader intraregional trade competition, in turn, could increase the need for a regional structure to help manage the transition and conflict.

Mr. AHEARN. Thank you, Tom. We'll now ask Fred Brown to comment on Ed Lincoln's remarks. Mr. Brown currently is a Senior Associate at the Carnegie Endowment for International Peace in Washington, D.C. He formerly served as a Foreign Service Officer, U.S. Department of State and from 1984-87 was a member of the professional staff of the Senate Foreign Relations Subcommittee on East Asian and Pacific Affairs.

Mr. Brown, please.

**STATEMENT OF FREDERICK Z. BROWN, SENIOR ASSOCIATE,
CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE**

Mr. BROWN. As an economic illiterate, let me say first that Ed Lincoln has written a valuable paper on something that I've never understood very well—Pacific Basin economic integration. However, be it formal, informal, institutionalized, or noninstitutionalized, I've been instinctively suspicious of the concept even as a partial recipe for prosperity in Asia and the Pacific. So I'm very grateful to Ed for his paper.

I take it as Ed's bottom line that while economic ties in the region are thickening, preferential trading arrangements or other institutional multilateral arrangements within the region would not necessarily work in favor of U.S. national interests. The label "country of origin unknown" may be a product label more compatible with our own economic system. It seems obvious to all of us that economic and trade irritations in East Asia are assuming extraordinary proportions, politically and strategically.

A central task of U.S. policy toward the region must be to manage these economic and trade tensions in a way which does not undermine our security interests. I think many of us have heard Richard Holbrooke, former Assistant Secretary of State for East Asia and the Pacific, expand on one of his favorite theories—the disconnect between U.S. economic and political policies and attitudes in Asia. For example, how the public and media hysteria over the trade imbalance with Japan impacts adversely on the

larger dimension of our crucial strategic interests and threatens one of our most valuable bilateral relationships. Now Ed's point, if I understand him correctly, is that from what we could see in 1988, trading arrangements such as PFTAD, PBECC, PECC, and OPTAD would probably not have the effect of soothing these irritations or removing the root causes of tension, at least in the manner acceptable to the United States. I also gather that such arrangements are unlikely to be consummated in the near future.

It seems to me that four key points emerge from Ed's paper, and these will be, I think, developed in our sessions throughout the day. I think they are relevant to how ASEAN and the individual countries in Southeast Asia view integration regionally and how they see their own economic futures.

First, Japan and the U.S. have come to dominate intraregional trade in East Asia Pacific and are likely to continue to do so for quite a while, with a gradual erosion of the U.S. share. We have already established that, I believe.

Second, the countries of the region are by any measure a very disparate lot. Japan and the U.S. are in a league by themselves.

Third, the China card: while China is currently a minor player, but no one doubts its immense potential in the 21st century. How it fits into the pattern of regional trade and finance is one of the big question marks economists and political scientists see as important. It strikes me as unlikely that China would find it useful to join an integrative Pacific arrangement. A more germane question is how Hong Kong after 1997 will multiply or otherwise affect China's economic power and its involvement in the Pacific region generally.

And fourth, and most significant, of course, Japan—its "special problem," as Ed calls it—the legacy of the war, its import protection inclinations, its mercantilist foreign aid program, and the question of how Japan may begin to play its cards somewhat differently and in ways that would threaten even more U.S. trade and economic interests. With all due respect to Roger Severance, it would be a mistake, it seems to me, to assume that Japan is not going to adapt its practices or to improve its trading image. This would include opening somewhat to increase exports from ASEAN and other nations in the region in order to benefit Japan's own markets on the long term. So we're driven, I think, back to two conclusions.

First, that regional arrangements are really less significant than the possible new configurations of bilateral trading ties—Erland Heginbotham's "complimentarities," if you want, which may be to the advantage (or to the disadvantage) of the United States and which certainly have strategic overtones.

Second, that the central concern for the United States must be Japan and our ability to adjust to new realities—how to avoid the disconnect in U.S.-Japan relations. If economic irritations between the U.S. and Japan get worse, there will be inevitable deterioration of trust and cooperation on security matters.

Beyond Japan I think it would be difficult to overemphasize the political importance and security connotations of the U.S. relationship with ASEAN. We are already seeing political spinoffs from trade irritations there. The Thais are unhappy about the invasion

of their traditional rice markets. The close U.S.-Thailand alliance is undergoing strains, and trade is one of the reasons. Intellectual property and copyright problems have been painful all over Asia, but especially so in Thailand, Singapore, and Indonesia. Another earlier example was tin dumping by the U.S. General Services Administration—a particularly neuralgic issue in U.S.-Malaysian relations for decades. This strain was eased through persistent negotiations and a low-key bilateral memorandum of understanding agreement. It's worth noting that both sides were careful to avoid the disconnect between trade and political issues even though there was a lot of potential for "American bashing" by Kuala Lumpur. Discontent over tin did not prevent enhanced U.S.-Malaysian security cooperation in the early 1980s, and indeed that continues today in a mutually beneficial way. A less felicitous example is Singapore today. It's possible, I think, to connect the current anti-U.S. campaign there on grounds of interference in their political system with Prime Minister's Lee's unhappiness over intellectual property rights and the U.S. failure to come to grips with its huge budget deficit. The Prime Minister has, of course, lectured us time and again on the latter subject. Let us hope that Singapore's fit of pique will pass.

Let me mention parenthetically that we have just witnessed Prime Minister Bob Hawke politely point out that the U.S. Agriculture Enhancement Act have the effect of gouging Australia's tradition of overseas wheat markets rather painfully. Yet to his credit, Hawke has tried to ward off a backlash against the U.S.-Australian Joint Facilities which serve important U.S. space and military interests. It's a tough job and we certainly have no assurance that Bob Hawke's successor will be as successful in managing the Australian political disconnect.

Let me mention the anomaly of Viet Nam. It is, after all, in Southeast Asia. Vietnam's future status demonstrates the close connection between economics and political security matters. ASEAN has as its ultimate goal "plugging Viet Nam into the western grid", as the venerable Singapore foreign policy guru S. Rajaratnam puts it. The geopolitical and security implications of breaking Viet Nam away from the communist economic bloc and the relationship with the Soviet Union politically and militarily—reducing Soviet clout in Indo-China—far surpasses the tiny economic or commercial gains that would accrue to ASEAN, or in time, to the United States. Japan is in a position to play a key role in financing the integration of Viet Nam's economy into the noncommunist world.

Finally, the Philippines—a basket case economically at present, but clearly a country with immense potential and geopolitically important to ASEAN as well as the United States. Japan and the NIC's are being asked to provide development assistance to the Philippines in a cooperative effort with the U.S. and the ASEAN states. It is all for the common good of creating political stability in the Philippines through economic stabilization and growth.

I think this is important and we may want to talk more about the Philippines in the context of regional cooperation, if not integration. So I think I'll stop there.

Mr. AHEARN. Thank you, Fred. Ed, do you care to respond?

Mr. LINCOLN. Maybe just one thing. I want to reinforce the idea that Asia is a region where the primacy of economics seems to be increasing. The states that have their cast off ideological rigidity are the ones that have done very well economically. It's economics that has driven Taiwan towards political accommodation with China, through the fear of being left out of Chinese markets as everyone else goes charging in. Of any of the regions of the world, this is the place where economic developments are exciting and the economic issues often are the most important ones. Many of the strategic issues are reasonably under control. This situation is likely to continue for some time.

Mr. AHEARN. We have about 10 minutes left for comments and questions. We'll begin with Mark Borthwick who is with the U.S. National Committee for Pacific Economic Cooperation (PECC).

Mr. BORTHWICK. Let me begin with what I think should be a correction about the OECD view of the NICs. I've had a number of phone calls from the OECD in Paris over the past year, and the staff there indicates a 180-degree change from a year ago on the OECD's attitude towards the NIC's. The ministerial meeting in Paris did announce a fundamentally different approach to the NICs from previous years and I think the international conference that they indicated announced would take place will have Japanese support.

Concerning the PECC, there seems to be some misconceptions about its nature and how it works. The PECC functions in many respects as if it were a quasi-governmental institution. It was created in 1980 at the initiative of the prime ministers of Australia and Japan, yet it cannot be called a governmental body. At the recent meeting in Osaka, the heads of the U.S. delegation were private individuals, former Ambassador Richard Fairbanks and the Director of Morgan-Stanley, Fred Whittemore. On the other hand, one of the persons seated at the table over two days of talks with his counterparts from all over Asia was Michael B. Smith, the Deputy U.S. Trade Representative. When the executive committee of the PECC sits down in a conference room, the individual representing China is someone whom senior officials have considered to be their counterpart in Beijing. Seated directly across the table from him is an equally senior policy-leader from Taiwan. That gives you an idea of why, a regional institution if one is going to evolve in the Pacific, can't be modeled on the regional institutions of Europe, Latin America or anywhere else. There are at present too many constraints on the kinds of dialogues that can take place between governments in the Pacific. I hope personally that the PECC will be the precursor of a stronger regional institution. That is, eventually, we will need to develop something beyond the PECC. Nevertheless, what is being said about regionalism here, I think, belies what is actually going on.

At the PECC meeting in Osaka the governments through their respective Committees, indicated they will support a regional fund for Pacific Economic Cooperation. Basically, it is seed money to begin a regional institution. As such, it's a symbolic gesture, but the idea is that it could grow into a significant amount of money over the coming decade. So I would just say in light of the new attitude by governments, that the kind of debates that we see about

regionalism really need now to go beyond the previous late 1970s or early 1980s discussions about the "Pacific Community." That is a dead term. Even Gorbachev in his Vladivostok speech understood that it is a dead term. He said that the USSR had been offended by talk of a "Pacific Community." On the other hand, it likes idea of "Pacific Economic Cooperation," the only real change having been Soviet policy toward the idea.

On the role of Japan specifically, there is a suggestion that Japan might be interested in a Western-Pacific consortium of some type. Some soundings appear to have been taken on this prospect in Southeast Asia by Japan, but I think they're a long way away from getting a positive response to that kind of initiative. The U.S. works with Japan in the regional context, we do have useful bilateral meetings, and they demonstrate a very strong desire to cooperate with the United States.

One point about PECC's interaction with the USSR. The Soviets since Gorbachev's Vladivostok speech appear to wish to join the PECC along with a few other countries like Chile and Mexico. Their major initiative has been to create the Soviet National Committee for Asia-Pacific Economic Cooperation, apparently named so as to position it as a candidate for PECC membership. It includes the very top rank of Soviet officialdom and unofficialdom that is responsible for Asia-Pacific matters. It is headed by Yevgeniy Primakov who attended the Osaka conference and made a very tactful, brief but impressive speech to the conference. The Soviets are, I think, making very good headway by using their national committee in this way. They scored an immediate coup in getting the Australian National Committee in Osaka to agree to a bilateral meeting in the USSR this summer. It's that kind of strategy that we should expect them to use very effectively. On the other hand, the momentum of the Pacific Basin economy still is running against them as the heirs of the Stalinist economic structure. For the reasons that have been mentioned here, they really are not able to participate broadly in all the issues of the PECC. They have no idea how to enter a debate on GATT-related issues of the sort we had with Mike Smith and the other negotiators. On the other hand, I do think that we're going to see initiatives in the Soviet Far East that are going to be quite surprising, including the general region of Vladivostok. I think in the next couple of years we might see a special economic zone emerge in that area assuming that Gorbachev's reform efforts survive that long.

Mr. AHEARN. Thank you Mark for those insights. Martin Weinstein from the Center for Strategic and International Studies (CSIS) has his hand up.

Mr. WEINSTEIN. I want to direct my question to Ed Lincoln. I think you said several times that if some kind of a Pacific regional economic structure were to be formed, Japan would try to keep the United States out of it. And I just wonder if you would explain why you think that.

Mr. LINCOLN. Number one, we do export a lot of manufactured goods to Asian countries. We often compete very effectively against Japanese products in those countries. We are less successful in Japan, and I think that Japan would follow the policy or behavior patterns that keep American products out of Japan to other coun-

tries. If the Japanese were able to put together such an organization (which is still unlikely), one of their intents would be to create a better market for Japanese products. Perhaps this would be motivated by some fear that the United States is becoming more protectionist, that a regional block would be an alternative. Then Japan would begin to project its trade policies on other Asian countries. How? Well, there could be intensification of some of the things we see already with the Japanese. For example, that if Japanese financial institutions lend money to corporations in other Asian countries, there is a condition in those loans that only Japanese products be bought. There have been cases where manufacturers in Southeast Asia have tried to substitute an American product for a Japanese product. Even though the substitution was just one of the many inputs, within 24 hours the Japanese financial institution lending them said that if they try to do that, all the loans would be called in. An intensification of that process would take place. In addition, more unity of purpose in Japanese foreign aid goals and greater tying of that aid to commercial purposes could take place. The reason I say it is unlikely is that there is a trend in Japan away from some of this narrow reasoning. Certainly in foreign aid policy there has been some movement. There is also a great debate in Japan, with many expressing genuine concern for the needs and desires of developing countries. But there's still a very strong mercantilist or commercial self-interest involved in a lot of what happens, and what's going to happen over the next 10 years is still up in the air.

Mr. AHEARN. Frank Ballance from the Bretton Woods Committee is asking for a follow-up.

Mr. BALLANCE. The follow-up is to ask Ed Lincoln to comment on proposals for a Japan-U.S. free trade agreement. Because it seems like such a nonstarter for many reasons, I wonder if Japan has a hidden agenda in proposing it? That is, if the bilateral proposal does not fly, then perhaps there will be groundwork laid in terms of a public rationale for promoting a regional trade arrangement.

Mr. LINCOLN. That's a possibility. I don't think that's a very strong motivation for the Japanese. I don't think they've thought it through that far yet, but that's certainly a possible development. One of the very peculiar things about the Japanese interest in a bilateral arrangement with the United States is their strong but disguised interest in it. When I am in meetings with the Japanese and they bring up the issue, I tell them the United States is very interested. The Japanese claim that they are not interested themselves, but that the United States is pushing this idea. This is based on the fact that Senator Byrd and Ambassador Mansfield have mentioned the idea. When I try to stop the conversation at that point, the Japanese want to talk about it for hours and hours. They really do have a strong interest in this idea even though they try to disguise it.

There's no harm in the Japanese putting a proposal on the table, but frankly, I don't think they would be willing to address the issues that we would find absolutely necessary to be addressed in such an arrangement. The problems with Japan are not very much in the area of tariffs; not very much even in the area of quotas.

Theoretically we have just solved the last big quota issue with Japan (beef and citrus). It's other practices—which often the Japanese deny even exist—that keep that American market share in Japan low. If they claim there's no protectionist behavior, how can they do eliminate it in a free trade zone? And if do not, then we should not be interested in a deal, especially when the bilateral trade imbalance is so large. So I think the idea would founder.

Mr. AHEARN. One last question before we adjourn this panel? Mike Bennetiell from the Department of Commerce.

Mr. BENNEFIELL. It strikes me that Fred Brown has been extremely helpful in talking about the disconnect between U.S. economic and political policies in Asia. But I'm tempted to ask at this point, will the real U.S.-Japan bilateral relationship please stand up? It seems to me there are two models that we have to look at. One is U.S.-Japan military strategic cooperation where fundamental interests are complementary. The other is trade and industrial competition where interests are fundamentally hostile and inimical. There are, in fact, limits on how the U.S. and Japan will participate. Are Japan's national economic interests and future role in the region inimical or complementary to U.S. national economic interests in the future role in the region?

Mr. AHEARN. We will be addressing that question during the first panel this afternoon. I don't know if any of our panelists want to give it 30 seconds?

Mr. LINCOLN. That's a good question and I think I owe 15 seconds. It's not necessarily true that we've always had the same national interests. I think there's a great tendency when meeting with the Japanese to talk about how the United States and Japan are very close or to say that we have a common national interest. But sometimes we don't. That doesn't necessarily mean the relationship is going to fall apart. But we must find a way to address the differences and figure out how to make something work without a complete breakdown.

Mr. AHEARN. We're going to adjourn this panel. I want to thank Ed Lincoln, Tom Fingar, and Fred Brown for their contributions. Let's take about a 7 minute break. We're running a little bit behind schedule, but we're not going to shortchange the last panel of any time. We'll just have less time to eat.

PANEL 3.—POLICY CHALLENGES FOR NEWLY INDUSTRIALIZING ASIA

DISCUSSION LEADER: Stephan Haggard, Center for International Affairs, Harvard University

COMMENTATORS:

Anthony Albrecht, Chairman, Asia Society Corporate Programs, Washington Center

Ralph Clough, Coordinator, China Forum, Johns Hopkins School of Advanced International Studies

MODERATOR: Richard Cronin, Specialist in Asian Affairs, Congressional Research Service

Mr. CRONIN. I'm Richard Cronin with the Foreign Affairs Division of CRS, and I would like to say that it seems that we've already got on the table most of the themes that we're going to be talking about today, although we've not explored many of them in any detail. But the issues are out, and we're now going to shift our

focus from the big countries—Japan and China and the United States—to the newly industrializing states and their particular perspectives in the policy challenges that they face.

Our discussion leader is Professor Stephan Haggard. He's Associate Professor of Government, The Center for International Affairs at Harvard University. He's a Berkeley Ph.D. with a distinguished academic career. He's written widely on industrialization and political economy in the newly industrializing countries. Dr. Haggard, please.

**STATEMENT OF STEPHAN HAGGARD, CENTER FOR
INTERNATIONAL AFFAIRS, HARVARD UNIVERSITY**

Mr. HAGGARD. My assignment was to talk about the policy challenges facing the East Asian NIC's—Korea, Taiwan, Hong Kong, and Singapore. I'd like to begin with a little history. It's probably familiar to you, but I do it to make a particular point—that the foreign NIC's really shouldn't necessarily be treated as a group.

We tend to think of the process of industrial upgrading in the East Asian NIC's as beginning very recently, with the Hyundai Excel being the most compelling symbol. But already by the early 1970s, each of these countries have confronted external conditions that had generated policy debates concerning where the industrial structures were likely to go over the following decade. Those external conditions included protectionism, the form of which had particularly perverse consequences. Quota restrictions, meant that there was an incentive for each of these countries to seek to upgrade within product categories as well as out of them. Growth also began to be more erratic in the advanced industrial states over the 1970s. Perhaps most importantly, all of the East Asian NIC's began to face, if not labor shortages, rising real wages and the fear that they would be displaced competitively by countries with lower unit labor costs—Southeast Asia, and of course, behind Southeast Asia, the threat of China looming large.

Over the 1970s and early 1980s each of the four NIC's addressed this set of external conditions in somewhat distinct ways—ways that are revealing of different national policy styles. I want to underline this point because when we come to the policy issues facing the United States, it is very important to differentiate among the four. The countries are quite different and have pursued somewhat different growth trajectories.

To start with the Adam Smith end of the spectrum, Hong Kong wrung its hands a bit over these problems and issued a report on diversification in 1978, subsidized some land costs, and also organized R&D assistance to firms in certain sectors, but essentially the government did very little. Hong Kong relied on the market as the mechanism of adjustment. As you all know, Hong Kong is virtually the model of a *laissez-faire*; it doesn't even have a central bank. The adjustment process there has taken place almost wholly through market signals.

Singapore is quite different than Hong Kong. The government there relied heavily on its control of the labor movement and control over wage determination, to force upgrading on the foreign firms which dominate Singapore's manufacturing sector. In this,

Singapore is quite different from the others. In all the three other cases, there are strong national firms, strong entrepreneurial classes. In Singapore, manufacturing is virtually wholly dominated by foreign firms. In fact that domination has increased over the last 20 years. The strategy of the so-called second industrial revolution in Singapore was to allow wages to drift up quite rapidly and thus force more capital-intensive and technology-intensive processes on the foreign firms that were located there.

Despite these differences in strategy, both Hong Kong and Singapore have taken a number of policy steps over the last 15 years to enhance their positions as regional financial centers. In fact, the one thing that surprised me this morning is that there hasn't been more discussion of East Asia as a financial power and the shift in financial power as Tokyo emerges as an important financial center. In any case, Singapore and Hong Kong are very important regional financial centers.

Taiwan and Korea are different than the city-states. They're relatively large economies by developing country standards—fairly large internal markets given the fact that income per capita is relatively high and income distribution is relatively egalitarian. Taiwan sought to develop a set of intermediate and capital goods industries through the mechanism of the state-owned enterprise, fiscal incentives, support for local R&D, and also continued protection. And that's an odd characteristic of the export-led growth strategies of Korea and Taiwan. While they have pushed exports, they have simultaneously maintained levels of protection which are not high perhaps by developing country standards but are high by standards of the advanced industrial states. Taiwan also relied very heavily on infrastructure investment through a series of major projects over the mid to late 1970s.

Korea, finally, pursued the most aggressive strategy of industrial diversification, using its state-owned financial system—all the commercial banks until 1982 in Korea were in government hands—to accomplish two goals. One was to push into heavy and chemical industries: petrochemicals, power-generating equipment, and the like, and the second was to increase the concentration of the industrial structure by encouraging the growth of large conglomerate trading companies that are known as chaebol, which now account for about 50 percent of Korea's exports.

Now the point of this brief history is that all of the NIC's with the exception of Hong Kong have pursued quite interventionist economic policies, even if the exact instruments that they have used and the degree of conflict with American policy objectives has varied. Hong Kong and Singapore have been completely open to foreign trade and investment. In fact, in Singapore they bent over backwards to encourage it. And thus conflicts between the U.S. and the East Asian NIC's have existed primarily with Taiwan and particularly Korea, which has been the most interventionist of the four, and had the highest levels of protection and also the least open to foreign directed investment.

Over the early 1980's however, each of the four began to undertake a set of economic policy reforms that had the general aim of moving the economies in a more market-oriented, open and private sector-led pattern of growth. The reasons for this change in policy

were somewhat different in each case. The reform movement in Korea was in response to the excesses of the heavy and chemical industry push which had inflationary consequences. In Singapore, it was a response to the failure of the so-called second industrial revolution—1985 was a very bad year—as well as domestic private sector concern that the balance of incentives and the strategy of growth was tilted too much in the direction of the multinationals and the government.

In Taiwan, a number of financial scandals in the early 1980s revealed the deficiencies in the development of the financial sector and domestic banking system. Even Hong Kong had to make some adjustments following a fairly severe financial crisis in 1983 connected with the negotiations with China, that in my view tend to underline the colony's vulnerability to external political forces.

More generally, a consensus developed within policy circles within the bureaucracies of the NIC's themselves that past interventions led to inefficiencies; this was particularly true in Korea and Taiwan. As the complexity of these economies increased, it was necessary for the government to step back, to reduce its directive role in the economy—a kind of process we've seen operate in Japan as well.

The second general factor was a gradual shift in U.S. trade policy which might be dated from President Reagan's September 1985 speech after which the United States became more aggressive in pursuing the new issues on the Tokyo round agenda bilaterally, and also seeking to open markets and increase access for American firms investing in the NIC's.

These reform efforts and increased American pressure developed against a backdrop of important political changes in each of the four cases. In Korea, a formal change of regime in a democratic direction has taken place, which was spurred in part by student activism and has subsequently been accompanied by an upsurge in labor activism. In Taiwan, the process is equally dramatic, though the problems are somewhat different. You have a one-party government, essentially modeled on a Leninist party, that is allowing the formation of opposition parties. The legislature is becoming a very active place; fist fights have even taken place. Demonstrations in May involving several hundred people targeted government plans for agricultural import liberalization. In Singapore, the one case of the four that seems to be moving in the opposite direction politically from the others, a transition is taking place that's primarily a generational one between Lee Kuan Yew and the so-called Old Guard to his son and a number of other younger technocrats. The political issues facing Hong Kong are generally phrased in terms of 1997 and the colony's incorporation into China, but a neglected component of that process is a quite lively debate about the nature of government prior to and after 1997. The left in Hong Kong is pro-Peking, but they're conservative on domestic political issues. In fact, they favor a maintenance of the colonial form of government that Hong Kong has had up until now. There are tremendous ironies: a pro-Communist business class favoring a maintenance of the colonial relationship. And then on the other side, a number of political "pressure groups", as they are known, arguing for greater

democratization, more electoral representation in the legislative council, probably without too much success.

Particularly in Taiwan and Korea these sets of political changes pose a particular political bind for the political leaderships. Some of the economic reforms are politically popular everywhere, like tax cuts as we know from the United States in 1981 or privatization. But others, while they may have longer term beneficial consequences for the economy as a whole, have short-term distributional costs. And here I'm thinking primarily about import liberalization and currency appreciation. Previously, the political leaderships that previously did not have to deal with domestic constituent pressures at all—in fact, such political “insulation” was a fundamental component of the NIC model. Politics was suppressed. Now these leaderships are caught between external pressures, economic exigencies, and a new set of electoral constraints that didn't exist in the past. Thus the political process is now going to affect the pace of reform.

Now let me just touch quickly on a couple of the main reform issues in the four cases: as you will see, they parallel closely the U.S. reform agenda vis-a-vis the Asian NIC's as well.

The first and most important issue is trade liberalization, which is not only a response to external pressures but also a way to solve the various inefficiencies that have been associated with fairly high levels of protection in the past. Both Korea and Taiwan have launched fairly extensive trade liberalization programs. The problems are likely to come, as they have in Japan, not with the formal policy restrictions but with other barriers such as the industrial structure, retail system, and so forth, that block imports. The problems in trade liberalization, are likely to be two-fold. One, are the Japanese going to be the main beneficiaries of this liberalization? Taiwan and Korea are very concerned about that possibility, since they see trade problems in political terms and are trying to design the liberalization in such a way that it will benefit the United States disproportionately. In addition, they have their own trade deficits with Japan.

But the main political issue—the big political issue in both cases—has come less in manufacturing than in agriculture. Korea and Taiwan have followed the European and American pattern of essentially subsidizing agriculture quite heavily, protecting agriculture quite heavily, as comparative advantage shifts away from it. The political dilemma is that both KMT and the ruling party in Korea have built their political bases of support around the rural sector—a pattern also similar in some ways to Japan. So those are the issues that despite the recent apparent agreement on beef, I think, are likely to remain on the agenda.

The reform of the services sector, and particularly the financial sector, has been a second issue in Korea and Taiwan. Hong Kong and Singapore as I mentioned are highly developed financial centers. There are really three distinct issues here, each of which has some implications for U.S. policy. They're often confused. The first is liberalization and deregulation. Both of these economies have developed quite rapidly, but their financial systems remain heavily repressed, heavily controlled. The issue here is the creation of new

financial intermediaries. The second issue is privatization, which occurred formally in 1983.

Mr. BENNETT. The stock was sold off, but the minister of finance still runs the financial system.

Mr. HAGGARD. That's the exact point I was going to make. And in Taiwan there hasn't even been a move towards privatization—so you have liberalization and deregulation and privatization. The third issue, finally, is internationalization which includes not only the liberalization of the capital account—a tricky issue as we know from the Southern Cone cases in Latin America—but also the entry of foreign banks, insurance companies, security firms, and the like. There are number of technical problems in this process, for example, the exact sequence the reform should take. But the political problem here has been resistance by the Minister of Finance in one case, and the Central Bank—a very powerful Central Bank—in the Taiwan case. And though the U.S. has made some gains in securing entry for U.S. banks, I think this is going to take a very long time—the liberalization of financial sector in both cases will be gradual.

Now finally the third issue which has been put on the table already is a macroeconomic policy issue, which in the U.S. seemed to have been largely equated with exchange rates, and have centered initially on currency depreciations. When the dollar started coming down in 1985, all the foreign East Asian currencies came down with it. Recently there's been some appreciation. Marcus Noland made the interesting point that the "Gang of Four" might be in a kind of prisoner's dilemma, where no one can move in the exchange rate because of the fear of loss of competitiveness vis-a-vis one another. But there's also a domestic-political dimension of this. The very export orientation of these economies has created a powerful political constraint on more rapid appreciation. And this actually affects people who know better—the economists. I was just at a conference in Taiwan with some of the most eminent economists on the island and I was amazed at the number of reasons they could list for why Taiwan, basically a developing country despite Marcus' figures, should be exporting capital in the form of low-yielding investments to the rest of the world while making their own monetary management almost impossible. And I think it has to do with the fact that the economies are so trade-oriented. You have a very, powerful bloc of firms that have no interest in appreciation, and one interesting indicator of that is seen in Korea. The large firms have gone along with import liberalization, but the reason why is because they see it as a political alternative to appreciation.

The main macroeconomic issue has been cast in terms of exchange rates. I don't think that's really the whole picture. The real question is: what is the mix of adjustment measures that are appropriate for these economies to take? It seems clear that even if these economies liberalized imports 100 percent, that it wouldn't make a dent in their surpluses, particularly in Taiwan. I think this is really a fanciful notion that somehow we can solve the bilateral trade imbalance through getting these countries to liberalize. I don't see that as being the case. We need to talk about a broader set of measures which include increased investment in social services, and infrastructure. Those of you who have been to Seoul and

Taiwan recently, pollution control—they certainly can invest in pollution control; allowing wages to rise, and I think the real policy debate in these countries is centering on the mix of these measures. It's not just appreciation, but what are the accompanying macroeconomic policy measures that go along with that. And here as you can imagine politics is going to play a role. I think ultimately these economies are going to have to move in a more inward-oriented direction than they have in the past, and there's some evidence that there's political pressure moving in that direction in both Korea and Taiwan.

Let me make two points in conclusion. The first is as I've suggested, the NIC's really can't be treated as a group in policy terms. There are very few outstanding policy issues with either Hong Kong or Singapore. In my view, there are relatively few issues with Taiwan as well, which leaves Korea. And here I think the U.S. runs a risk which should at least be acknowledged, which is political backlash. There's a benefit in pressing at certain moments, but there's also a risk of anti-Americanism. I spent a lot of time with students on this last trip, and the degree of anti-Americanism is quite astonishing—a sharp difference from even 5 years ago in the level of sentiment.

The second point I want to make, is that we tend to conceive our policy toward these countries in very narrow sectoral terms—that is, we're going to handle beef; we're going to handle insurance; we're going to handle these particular issues. That's probably necessary, but what is now needed is a broader policy dialogue that would talk about the overall policy direction we want to see some 5 years or 7 years down the road. And here I agree with Ed Lincoln's heresy that one way of doing that perhaps would be to try to incorporate the NIC's into the OECD—not only for economic reasons but also to encourage their "graduation" for domestic political reasons in each of those countries.

Mr. CRONIN. Thank you, Stephan. You've given us quite a lot of things to talk about here and discuss. Your prepared statement will be inserted in the record.

[The prepared statement follows:]

PREPARED STATEMENT OF STEPHAN HAGGARD, DEPARTMENT OF GOVERNMENT AND
CENTER FOR INTERNATIONAL AFFAIRS, HARVARD UNIVERSITY

POLICY CHALLENGES FOR NEWLY INDUSTRIALIZING ASIA

The East Asian NICs: Patterns of Policy

The success story of the East Asian newly industrializing countries (NICs)—South Korea, Taiwan, Singapore and Hong Kong—is well known and need not be retold in detail.¹ All industrialized by pursuing "outward-oriented" growth strategies that emphasized the export of labor-intensive manufactures. Despite shocks from the international system over the 1970s and 1980s, the NICs have sustained high levels of growth. Economic performance and export growth in 1986 and 1987 were particu-

¹ For an overview of the NICs, see Walter Galenson, ed., *Foreign Trade and Investment: Development in the Newly Industrializing Asian Economies* (Madison: University of Wisconsin Press, 1985); Stephan Haggard and Tun-jen Cheng, "State Strategies and Foreign Capital in the East Asian NICs," in Fed Deyo, ed., *The Political Economy of the New East Asian Industrialism* (Ithaca: Cornell University Press, 1987) and Tun-jen Cheng and Stephan Haggard, *Newly Industrializing Asia in Transition: Policy Reform and American Response* (Berkeley: Institute of International Studies, 1987).

larly strong, aided by the "three blessings" of low oil prices, low inflation and currencies that have depreciated sharply against the yen.

The American attitude toward the NICs exhibits a certain ambivalence. All four are pro-Western in their political orientation, and Korea is a strategically important ally. All are important trade and investment partners. The NICs have also been held up by the United States as models for other developing countries to emulate. The four countries achieved rapid growth while maintaining levels of employment and income distribution that compare favorably with the advanced industrial states. They did this by pursuing policies which is not *laissez-faire* were broadly market-conforming. On the other hand, the success of the NICs has created adjustment problems in the United States, leading to fears that they constituted "little Japans." These concerns have grown substantially over the last three years.

Despite their success, the East Asian NICs have faced a number of external constraints on the export-led growth model. The first constraint is protectionism in the advanced industrial states, which has had unintended and somewhat perverse consequences.² By restricting imports through quotas, the United States and Europe generated rents for the exporting countries and encouraged upgrading within particular product categories. Protection provided an incentive to diversify away from light, labor-intensive manufactures. The second constraint was a side-effect of the NICs' very success. Rapid growth and the absorption of labor led to rising labor costs. Business and government in the NICs began to fear that they would be displaced by a "second tier" of low-cost exporters, including particularly China with its virtually unlimited supply of labor. Third, automation and technological change also threatened to erode previous advantages in low-wage production. At the same time, investors and suppliers, from Japan in particular, were increasingly wary about the "boomerang effect"; the creation of new competitors by transferring up to date products and processes. Finally, the resource-poor and trade-dependent NICs faced severe macroeconomic and price shocks, including the two oil shocks and slowed growth in major markets.

Despite the broad similarities and the fact that they are frequently treated as a group, the NICs have followed different development strategies.³ Over the 1970s, each of the NICs adjusted to the changed international environment in ways revealing of these differences. Hong Kong represented one extreme. Heavily dependent on textile and apparel exports, Hong Kong was particularly concerned about the broadening and tightening of the restrictionist Multifibre Agreement that managed world textile and apparel trade. An Advisory Committee on Diversification was formed in 1977, institutional efforts were made to increase productivity and land costs were subsidized to land-intensive industries. Overall, however, Hong Kong depended on the market to adjust. Trade and investment policies remained completely open, taxes low, and fiscal policy conservative. As a result, the economy continues to be built around an every-shifting mix of light, labor-intensive industries and a rapidly growing service, financial and commercial sector encouraged by the colonial government's consistently *laissez-faire* stance.

Unlike Hong Kong, Singapore's manufacturing sector is dominated by foreign firms. The government also plays a much more pervasive role in the economy; through state-owned enterprises, through a large forced savings program (the Central Provident Fund) and through its centralized control over the labor movement and wage determination. In 1979, the government launched a "Second Industrial Revolution" (SIR). The core of the SIR was to use a "corrective" wage policy to place pressure on labor-intensive industries to either upgrade their operations through new investment and the application of new technologies or to move into new activities altogether. Though the government became more discriminating in its approach to foreign investment, trade and investment policy remained open, reflecting the country's small size and its efforts to compete with Hong Kong as a financial center.

Both the adjustment problems facing the two larger NICs and their policy options were different than those facing the two city-states. Korea was the most aggressive and interventionist of the NICs in pushing into heavy and chemical industries over the 1970s. The government used its control over domestic credit allocation through the state-owned banking system, extensive foreign borrowing, protection and conditions on foreign investment to promote an ambitious Heavy and Chemical Industry Plan. "Strategic" projects in the steel, petrochemicals, electronics and machine tool sectors received heavily subsidized finance. The government also sought to increase the concentration of the industrial sector by encouraging the growth of large con-

² See David Yoffie, *Power and Protectionism: Strategies of the Newly Industrializing Countries* (New York: Columbia University Press, 1984).

³ See Cheng and Haggard, op. cit.

glomerate trading companies, or *chaebol*. The objectives behind the creation of the chaebol were multiple, including replacing the Japanese trading companies and developing a domestic defense industrial base.

Historically, Taiwan has pursued a more cautious economic policy than Korea: a lower tolerance for inflation; more conservative monetary and fiscal policies, with higher levels of domestic savings and correspondingly lower levels of foreign borrowing. Levels of protection have also been lower, though by no means liberal, and the investment regime has generally been more open to foreign direct investment than in Korea. The government did play an important role in upgrading industry over the 1970s, however. State-owned enterprises were established in "strategic" sectors such as steel, shipbuilding and machine tools and fiscal incentives and various supports were also deployed. Nonetheless, the strategy was more cautious and the major government initiatives came in large infrastructure projects.

In sum, all of the NICs with the exception of Hong Kong have pursued quite interventionist economic policies; the four can hardly be taken as models of *laissez-faire*. The exact instruments they have used, however, and thus the potential for conflict with U.S. economic policy objectives, vary. Hong Kong and Singapore have been completely open to foreign trade and investment, and are major regional financial centers with a strong U.S. banking presence. Conflicts have thus existed primarily with Taiwan, and particularly with Korea which has been the most interventionist and protectionist of the four, the most mercantile in its export-promotion strategy and the least open to foreign investment.

Policy Reform and Political Constraints in the 1980s

Beginning in the 1980s, Korea, Taiwan and Singapore began to undertake economic reforms designed to move their economies in a more open, market-oriented and private sector-led direction. The reasons for this reassessment varied somewhat from case to case. In Korea, reform efforts began in 1979 in response to the excesses of the heavy industrialization drive: inflation; balance of payments problems; surplus capacity in targeted industries; and relative neglect of the light manufacturing sector that remained critical to Korea's export success. In Taiwan, a blue-ribbon Committee for Economic Revitalization was formed in 1985 in the wake of serious financial scandals involving the state-controlled banking sector. In Singapore, a reform commission was formed in 1985 to review the country's faltering economic performance.

Two broader factors were also at work in the reform effort. The first was a new critique of government intervention among business, technocrats and the international development policy community. This critique focused on the cost of continued intervention given the growing complexity and maturity of the NIC economies. The second factor was a gradual shift in United States trade policy.⁴ Though the United States had carried on bilateral discussions with the NICs before, these widened to include a variety of new issues on the Uruguay Round agenda, such as services and agriculture, and focused more aggressively on market opening measures. Discussions and policy statements also broadened in 1986 and 1987 to include macroeconomic and exchange rate policy.

These reform efforts and increased pressure from the United States overlapped with important political changes in each of the four cases. These changes created a bind for the respective leadership, particularly in Korea and Taiwan. One important set of factors behind the NICs' rapid growth has been political and institutional. A number of analysts have argued that the NICs' success can be traced in part to centralized economic bureaucracies, a highly insulated policy-making process and relatively weak pressures from organized interest groups, including labor.⁵ These conditions are now changing, making the reforms such as tax cuts and privatization are capable of garnering wide political support, others, such as trade or interest rate liberalization, have short-term distributional consequences. Leadership are thus caught between external pressure from the United States, the economic need to undertake reform measures and the mobilization of new political forces.

⁴ The move toward a more bilateral approach gained momentum following Reagan's September 23, 1985 trade policy speech, contained in *Annual Report of the President of the United States on the Trade Agreements Program 1984-1985*. See Stephan Haggard and Tun-jen Cheng, "The New Bilateralism: U.S. Foreign Economic Policy Toward the East Asian NICs," in Stephan Haggard and Chung-in Moon, eds., *Pacific Dynamics: The International Politics of Industrial Change* (Boulder: Westview Press, forthcoming).

⁵ Perhaps the main advocate of this institutionalist approach is Chalmers Johnson, *MITI and the Japanese Miracle* (Stanford: Stanford University Press, 1982).

As with the reassessment of economic policy, the nature of political change also varies among the NICs.⁶ Korea's political change has been the most tempestuous. Chun Doo Hwan's military rule showed strong continuities with Park's authoritarian Yushin system, and probably a worse human rights record, but Chun maintained a public commitment to effect a transition to democratic rule. Debates centered on the question of whether the president would be elected directly or through an electoral college system favoring the ruling party. Chun's attempt to finesse constitutional reform failed in the face of widespread protest in June 1987. Nonetheless, Chun's successor Roh Tae-Woo still won presidency by a plurality in December when the two main opposition candidates, Kim Dae-Jung and Kim Young-Sam, split the vote between them. Despite evidence of electoral fraud, Roh's margin seemed decisive. Continuing dissatisfaction with the government was demonstrated in the National Assembly elections in April 1988, however, when the ruling party failed to capture a majority. Students have continued to protest the illegitimacy of the regime, but the broad-based protests of June 1987 are unlikely to be repeated. Assuming that the military will tolerate a full transition to democratic rule—an open question to some observers—major changes will take place in the Korean political system, including a more active role for political, the press and the legislature, a more activist labor movement and more open debate about economic policy.

The changes in Taiwan have been equally dramatic, involving the liberalization of a political system dominated by a single-party government. In 1986, the government tolerated the formation of opposition parties. A number of other changes followed, including the lifting of martial law, a permissive attitude toward union organizing and the formation of interest groups, a relaxation of restrictions on the press and the permission for family visits to mainland China. The death of Chiang Ching Kuo and the succession of Lee Ten-hui in January 1988 contributed to the pace of political change. Contrary to American press commentary, the transition demonstrated a high degree of stability and institutionalization within the government. Lee promised to extend the reforms, which will be discussed in a crucial KMT Party Congress in July 1988. Among the many unresolved questions are the need to reform an extremely complex institutional system, the future role of the ruling party, the Kuomintang, and the delicate issue of independence, which is of potential appeal to native Taiwanese. Despite the uncertainties, some features of the new order are clear and parallel changes in Korea: a more active role for the legislature, interest groups, opposition parties and the labor movement.

If political developments in Korea and Taiwan promising, those in Singapore have been much less so. Singapore's government conforms to the Westminster model of parliamentary democracy, but politics has been dominated since independence by the People's Action Party (PAP) under Lee Kuan Yew. From the mid-1970s, Lee and the first generation of PAP leaders—the "old guard"—have sought to cultivate a "second generation" of younger leaders. During this period of controlled succession, electoral support for the PAP, while still high, has eroded somewhat; the party captured 77.6 percent of the popular vote in legislative elections in 1980, but only 63 percent in 1984. The PAP leadership has signalled its intolerance of opposition by harassing one opposition MP out of Parliament and arresting a number of dissidents in 1987. This year, the dissidents' lawyers were also detained and an American diplomat expelled for maintaining contacts with the opposition. Relations with the foreign press have been an ongoing source of controversy. These developments should be interpreted in light of the PAP's concern about eroding support, the transition to a "second generation," and the likelihood of elections in the fall of 1988. There is electoral evidence of a growing public resentment to the PAP's intrusiveness, but the issues have been given an anti-foreign twist by the government itself.

Hong Kong's future revolves around its scheduled incorporation into China as a Special Administrative Region in 1997. While the main issues in the transition are frequently viewed as "external" ones, the question of China's interference is intimately linked with the evolution of Hong Kong's government prior to 1997. Despite the publication of a Draft Basic Law in 1988 which outlines Beijing's "one country, two systems" approach to Hong Kong's governance, important questions remain unanswered. While China has promised that Hong Kong's capitalist institutions will be left intact for fifty years after 1997, there are still questions about the separation between the two systems, the power of judicial review, and the extent to which Hong Kong will be allowed to govern itself. Curious coalitions have formed, with "leftist" pro-Beijing businessmen arguing for continuity with the colonial administrative structure against those pressure groups arguing for a more representative

⁶ The following draws on Cheng and Haggard, *op. cit.*

system. The financial crisis of 1983, which occurred in response to an impasse in the Sino-British talks, and the apparent increase in emigration among professionals and businesspeople, suggest that the colony's economy remains highly vulnerable to political events. If a greater degree of electoral participation is allowed, Hong Kong may also face new political constraints on its *laissez-faire* policy stance.

In sum, political change is occurring across the NICs. In general, the process involves a maturing of electorates, growing opposition to political controls and restrictions on civil liberties, and in Korea, Taiwan and arguably Hong Kong, a liberalization of the rules governing political contestation.

The implications of this transition for American interests are somewhat contradictory. On the one hand, the U.S. has an ideological interest in promoting democracy. On the other hand, political change will impose greater constraints on government decision makers. Policy debates within the bureaucracy have become more open and politicized. The private sector is more willing to voice its concerns over economic policy, and labor will play a more active political role than it has in the past. The move toward more competitive, democratic systems will politicize economic issues in an unprecedented way—even in Hong Kong—as opposition forces seek to capitalize on the government's mistakes.

U.S. foreign economic policy will play an important role in these domestic debates. In Korea in particular, but in Taiwan and Singapore as well, there are signs of anti-American sentiment tied in part to American efforts to negotiate economic liberalization. There is thus a delicate balance to be struck between political and economic interests. Diplomatic pressure in pursuit of economic objectives is wholly legitimate, but must be carefully calculated to assist, rather than impede, the domestic forces supportive of reform.

The interaction between economic and political change can be seen by examining briefly some of the major issues on the reform agenda, particularly in Korea and Taiwan.

Implementing Reform—Trade Liberalization

By comparison with many other developing countries, Taiwan and Korea have relatively liberal trade policies. Nonetheless, both countries have had bifurcated trade regimes, with low barriers or duty free entry for inputs to export industries, coupled with higher levels of protection on a range of final products.⁷ Because of mounting global surpluses and chronic bilateral imbalances in its trade with the United States, Taiwan has been under greater pressure to act. Since 1986, Taiwan has accelerated its trade liberalization program and even proposed the negotiation of a free trade agreement. A fairly dramatic lowering of trade barriers has taken place since 1980. In 1981, Taiwan's average effective tariff rate was 9.1 percent. In 1985, it was 7.6 percent and the goal was to reduce it to 5 percent by 1990. In 1987, two new packages of concessions were offered that would lower average tariff rates to 3.6 percent, roughly equal to American tariff levels. Nonetheless, there are variations among rates, and the United States has sought further cuts in tariffs on a number of products.

The Korean system has been substantially more protectionist. Liberalization has also been the subject of substantial controversy both within and outside the bureaucracy. Import-licensing is administered by the Ministry of Trade and Industry, which maintains close links with business and has used trade restrictions for industrial policy purposes. Liberalization of restrictive licenses, i.e., removing commodities from the list of products requiring prior import approval, has been the key ingredient of the import liberalization program Korea launched in 1978. In 1977, approximately half of all commodities demanded licenses. Following the completion of a five-year schedule launched in 1984, 96 percent of imports will be free of these restrictions. This so-called "import liberalization ratio" is used by Korean authorities to point to the dramatic liberalization that has occurred. In fact, this ratio does not reflect the value of trade liberalized in these product categories. Nor does it take into account tariff rates, which until recently remained high by developed, if not developing country standards. A five-year program of tariff cuts was initiated in 1984, however, and has been amended since to respond to U.S. requests.

The liberalization of manufactured imports is a goal of important portions of the economic bureaucracies in both Korea and Taiwan. Taiwan's persistent surpluses have created pressures to liberalize quite separately from United States policy. Though Korea's surpluses are more recent, liberalization is increasingly viewed as

⁷ For evidence on this pattern in the early phases of export-led growth, see Ching-tuan Lin, *Industrialization in Taiwan, 1946-1972* (New York: Praeger, 1973); and Wontack Hong, *Trade Distortions and Employment Growth in Korea* (Seoul: Korean Development Institute, 1979).

both an economic and political necessity by the larger, export-oriented firms. In both countries, import liberalization is viewed as preferable to appreciation. Political conflicts within and outside the bureaucracy will affect the pace of liberalization of manufactures and particular industries, but as long as both countries run large trade surpluses, the general direction of policy is likely to be liberalizing.

Three additional points should be made. First, it is not clear that the United States will be the main beneficiary of liberalization. Korea and Taiwan have both sought to define their programs in such a way that pressure from the United States will be eased, in Taiwan's case, by organizing buying missions to the United States. But Japanese firms are well-situated in terms of location and experience with the two markets to benefit from any market opening measures. Second, as is well-known from Japan, government policies are not the only barrier to greater U.S. exports. Finally, the recent surge in exports to both Taiwan and Korea demonstrate that import liberalization does not affect trade as powerfully as exchange rate and macroeconomic policies. The belief that trade liberalization alone will substantially affect bilateral deficits is misleading.

The most acrimonious conflicts over import liberalization are likely to occur not in the manufacturing sector, but in agriculture. Agricultural policy in Japan, Korea and Taiwan has followed a trajectory common to Europe; as comparative advantage shifted away from agriculture toward industry, agricultural protection rose.⁸ Between 1955 and 1982, the weighted average of nominal grain and meat protection increased from 15 percent to 166 percent in Korea, and from 21 percent to 55 percent in Taiwan. Particular features of the two political systems explain this outcome. In Korea, Park Chung Hee and the current ruling party built bases of support in the rural areas, which were heavily overrepresented as a result of a peculiar system of proportional representation. For reasons connected with its experiences on the mainland, the KMT has also been responsive to farmers' interests.

Despite high levels of protection for agriculture in the East Asian countries, Korea, Taiwan and Japan remain substantial agricultural importers. Unlike the EEC, farmers have not been able to respond to protection with expanded production and exports. East Asia's protection is thus less threatening to world agricultural trade than the EEC's.⁹

Nonetheless, the closure of agricultural markets in Japan, Korea and Taiwan has become a major source of trade friction with the United States. Negotiations with Taiwan have centered mostly on market access for major agricultural and food products, including beer, wine and cigarettes. Until 1988, these negotiations were not severely politicized. Taiwan partly neutralized pressures through its "Buy American" missions that have purchased over \$10 billion of American goods since 1978, much of it agricultural products. As recent demonstrations by farm groups demonstrate, however, the KMT is not immune from political constraints in seeking to liberalize its agricultural sector. Future negotiations will be more difficult than those in the past.

The political difficulties in liberalizing agricultural trade are even more apparent in Korea, where trade barriers are higher, farm debt is higher, the disparity between urban and rural incomes greater and electoral constraints more pressing. Roughly 40 percent of the product categories in which the United States has sought licensing liberalization or tariff reduction since 1983 have been agricultural products. Korean concessions have been slow to materialize, and have come in products Korea does not produce.

As the recent dispute with Korea over beef suggests, the liberalization of agriculture poses particular problems for Korea and Taiwan. Barriers to trade in agriculture have been higher than in industry. The nature of the structural adjustments required to meet U.S. demands are also more complex, including the creation of off-farm income through rural industrialization, increasing agricultural productivity and even farm consolidation. Given that the agricultural sector in the NICs does not pose any threat to the political problems are particularly acute, the current U.S. emphasis on agriculture appears misguided and politically counterproductive.

Liberalization and Internationalization of Services

The development of financial services in the NICs provides one of the sharpest contrasts between Singapore and Hong Kong on the one hand and Korea and

⁸ Kym Anderson and Yujiro Hayami, *The Political Economy of Agricultural Protection: East Asia in International Perspective* (Boston: Allen and Unwin, 1986).

⁹ Robert Paarlberg, *Fixing Farm Trade* (Cambridge: Ballinger for the Council on Foreign Relations, 1988).

Taiwan on the other.¹⁰ While the city-states are major financial centers, financial services have been state-owned, heavily protected and highly inefficient in the two larger NICs.

Liberalization of services trade is a top American priority for the Uruguay round, and was central to Reagan's trade policy action plan of September 1985. Service negotiations raise a number of issues that are different from trade in goods, however.¹¹ Many services are not really "traded," but involve a local presence by the provider of the service. The concept of "national treatment" is therefore the key principle in the liberalization of services. Where significant restrictions on entry or capital movements exist, however, national regulatory policies may be restrictive even where national treatment is granted. As a result, service negotiations can easily widen to include the regulatory structure itself.

The services market has been heavily restricted in Taiwan, and a new foreign investment law proposed in 1988 suggests that many services will remain closed to foreign investors. Nonetheless, the country's overall posture toward foreign investment has been more liberal than Korea's. In August of 1985, the U.S. submitted proposals for the liberalization of barriers to U.S. banking, insurance, shipping and motion-picture distribution and leasing. In August 1986, agreement was reached on an insurance pact that would grant free entry and full national treatment to American companies meeting certain minimal requirements. Leasing has also been liberalized, but cargo transport was only partly opened to foreign participation.

The U.S. banking proposal grew out of the lobbying efforts of American banks in Taiwan.¹² The banks sought permission to establish more than one branch office in Taiwan, and to gain access to local currency funding and Central Bank rediscount facilities. Initial response to these demands was slow, but following changes in the financial markets in 1986, these concessions were granted. Reforms that would ease entry for new foreign banks, give both local and foreign banks greater freedom to set rates and permit banks to accept short-term deposits, and make loans to individuals have been held captive to the broader issue of banking and financial market reform. Conservative forces in the Ministry of Finance and the Central Bank have slowed progress in this area.

Korea was targeted more aggressively than Taiwan for action on services. In the fall of 1985, the USTR initiated a series of 301 negotiations concerning insurance, film distribution and the intellectual property rights. A general agreement was reached in July 1986 that lifted some restrictions, though the actions taken were not considered satisfactory by the American business community.¹³ Among the restrictions limiting foreign participation were highly discretionary foreign exchange controls, licensing and registration requirements in construction and engineering and complete bans on foreign entry in advertising. U.S. demands gradually widened to include access to advertising, shipping, freight forwarding, telecommunications, accounting and legal services. Banking was a major point of contention. In May 1984, the Ministry of Finance announced a two-year liberalization of banking that would give foreign branches more equal treatment with Korean banks. Between 1983 and 1986, however, the foreign bank share of total *won* deposits was virtually unchanged despite the reforms.

Korea has contended that the service sector has been hamstrung by past government intervention. For example, the government has used the insurance firms as an instrument of monetary policy, while the newly-privatized commercial banks are saddled with non-performing assets as a result of past industrial policies. A study of Korea's bargaining position in the GATT is characteristic of the approach to the liberalization of services that is likely to prevail in both Korea and Taiwan:

"Industrial engineering, banking, insurance and advertising all appear to be Korea's infant service sectors. This means two things. It would be undesirable to admit foreign operations in infant sectors on an MFN basis and extend full national treatment to foreign firms. On the other hand, it would be desirable to have some foreign presence to stimulate innovation and learning. Thus, foreign operations may

¹⁰ For a review of the issues, see Augustine H.H. Tan and Basant Kapur, *Pacific Growth and Financial Interdependence* (Sydney: Allen and Unwin, 1985).

¹¹ A comprehensive review of the services menu is provided by Geza Feketekuty, *International Trade in Services: An Overview and Blueprint for Trade Negotiations*, unpublished ms.

¹² "National Treatment Issues Affecting Branches of Foreign Banks in the Republic of China on Taiwan," paper prepared by Kaplan, Russin, Vecchi and Parker on behalf of the foreign bank branches in the Republic of China, June 8, 1984; Jane Kaufman Winn, "Banks, Business and the State: The Taiwan Experience," paper for the Latin American Studies Association Conference, 1988.

¹³ American Chamber of Commerce in Korea, *United States-Korean Trade Issues* (Seoul, 1987).

have to be admitted to a limited degree and/or there may have to be qualified national treatment to admitted ones."¹⁴

Investment Issues

As with trade, the U.S. has few conflicts with Singapore and Hong Kong over investment. Taiwan's posture has generally been liberal as well, and Korea's, while restrictive, has recently been liberalized somewhat. Nonetheless, both of the larger NICs have imposed export and domestic content requirements on foreign firms.¹⁵ On a case-by-case basis, Taiwan has tied foreign investment approvals to minimum export requirements ranging from 5 percent to 50 percent of output. Generally, products also made locally face export requirements while those without local production do not, but the rationale for such measures is more complicated than simple protection. Under pressure from the United States, Taiwan reduced export requirements for firms in the export processing zones and dropped export requirements imposed on a Toyota branch plant that was planning to export to the United States.

Taiwan also used local content requirements in some sectors in order to foster local suppliers, parts and component industries. Korea developed even more wide-ranging local content requirements over the 1970s in connection with its heavy and chemical industrialization plan. Korea announced a series of measures liberalizing the rules governing foreign investment in the early 1980s, but U.S. investors complained that the practice of attaching terms to entry remains in place. As with other "new issues," negotiations center on a regulatory framework and on the degree of discretion exercised by investment screening authorities. There is therefore a case for moving toward the negotiation of Bilateral Investment Treaties with both countries. Exchange Rates and Macroeconomic Policy

The East Asian NICs generally avoided any major misalignments in their exchange rates prior to 1985. After the Plaza Agreement in September 1985, the currencies of all four followed the depreciating dollar, however, with substantial real effective exchange rate depreciations taking place through the first quarter of 1987.¹⁶ As the resulting trade surpluses became apparent, the United States opened informal discussions with Korea and Taiwan on exchange rates, and publicly pressured the four to appreciate. Concerns were not limited to the United States alone. A communique issued in February 1987 by the "Group of Six" (the Group of Seven minus Italy) noted that the NICs were contributing "importantly to the present pattern of global imbalances." It called on them to "assume greater responsibility for preserving an open world trade system by reducing trade barriers and pursuing policies that allow their currencies to reflect more fully underlying economic fundamentals."¹⁷ Since mid-1987, the currencies of Singapore, Taiwan and Korea have appreciated, though the Hong Kong dollar remains pegged to the U.S. dollar.

Discussions on exchange rates and macroeconomic policy with the NICs have been conducted by the Treasury Department. They have not been institutionalized, however, and have occurred in other settings, such as meetings of the Asian Development Bank, International Monetary Fund or such events as Roh Tae-Woo's inauguration, at which the American delegation was headed by Treasury Secretary James Baker. The discussions initially focused on specific exchange rates targets for the short-term. Again, as in trade policy, Taiwan proved more forthcoming than Korea, though neither countries' efforts have to date been accepted as adequate by the United States.

The political dilemmas created by demands for appreciation in the NICs are quite obvious. The very export-orientation of the two economies has made exporters the dominant sector of the business community, while non-tradeable industries and consumers have to date been politically weak. In both cases, exporters have expressed concern over further revaluation. As with trade policy, policy makers in Korea and Taiwan face a delicate balancing act between U.S. pressure and domestic imperatives.

¹⁴ See Soogil Young, "Trade Policy Problems of the Republic of Korea and the Country's Objectives at the Uruguay Round," paper prepared for the Rockefeller Trade Policy Project, Korean Development Institute, July 1987.

¹⁵ An overview of investment issues is provided in United States Trade Representative, *National Trade Estimate: 1986 Report on Foreign Trade Barriers* (Washington: USGPO, 1987).

¹⁶ Bela Balassa and John Williamson, *Adjusting to Success: Balance of Payments Policy in the East Asian NICs* (Washington D.C.: The Institute for International Economics, 1987). For a contending view, see Rudiger Dornbusch and Yung Chul Park, "Korean Growth Policy," *Brookings Papers on Economic Activity* 1987, 2.

¹⁷ "G-6 Communique," February 22, 1987, in Yoichi Funabashi, *Managing the Dollar: From the Plaza to the Louvre* (Washington: Institute for International Economics, 1988).

Both Korea and Taiwan have argued that their trade surpluses are not structural, an argument that is more convincing in the case of Korea than for Taiwan where surpluses appear chronic. Both countries have argued that current efforts to eliminate structural budget deficits in the U.S. will result in a reduction of bilateral imbalances over time, and that surpluses act as insurance against the reversal of favorable external shocks. In Taiwan's case, the argument for the maintenance of large reserves is buttressed by the country's precarious international political position.

The U.S. view, however, is that the surpluses *are* structural. As a result, bilateral discussions with both countries have widened to include policy reforms that go beyond trade liberalization and exchange rate adjustments. Unlike discussions with Japan and Germany, the U.S. has not publicly pressed Korea and Taiwan to adopt stimulatory fiscal or monetary policies, though Taiwan has launched another round of large infrastructure investment projects. The effect of German and Japanese stimulus on U.S. trade deficits has been overestimated by the Department of the Treasury; the argument is even more implausible in the case of the relatively small East Asian economies.

Nonetheless, a reduction of bilateral deficits with the NICs may be a worthwhile political goal in forestalling protectionism. In addition, the policy changes required of the NICs are generally in their own interest and should be advanced as such. Not allowing the currency to appreciate creates dilemmas for the conduct of monetary policy, including the costs associated with the massive sterilizations required to reduce the inflationary pressures associated with reserve accumulation. It is also an historical anomaly for developing countries to export capital by holding low-yielding foreign assets while ample investment opportunities exist at home.

Discussions have addressed in a preliminary fashion elements of the financial systems of the two countries, including both domestic credit allocation policies that discourage consumer and mortgage lending and encourage exports. There is a presumption in U.S. policy pronouncements that capital market liberalization is desirable. If the Yen-Dollar Agreement of 1984 is taken as a model, U.S. policy could move more explicitly toward encouraging the NICs to liberalize barriers against the inflow and outflow of capital, internationalize their currencies, extend more favorable treatment to U.S. banks and other financial institutions and deregulate capital markets to allow interest rates to be determined by the market.¹⁸ There is a major difference between discussions on financial policy and discussions on sector-specific trade issues, however. In trade discussions, the United States wields not only the diffuse threat of Congressional action, but the specific threat to retaliate via Section 301 action. No such comparable instrument exists for financial market liberalization. Initiating 301 action on exchange rates or the financial sector would constitute a major departure. Nor is it clear what form retaliation would take.

As the discussion of service market liberalization has already suggested, the internationalization of capital markets in Korea and Taiwan is likely to move very slowly. Though commercial banks have formally been privatized in Korea, both banking systems remain under government regulation, and domestic deregulation would have to occur as a prelude to internationalization. Opening of the securities markets has begun in both countries, but the steps taken to date have been extremely cautious. Yet even were internationalization to move more rapidly, it is not clear that such policy reform would be desirable from the point of view of achieving stronger currencies in the two NICs. If there were a large net demand for Korean and ROC assets—which would probably be based in part on speculative inflows in anticipation of appreciation—then liberalization would result in a reduction of U.S. trade deficits via appreciation of the NIC currencies. But if liberalization results in a capital *outflow*, the effect on the exchange rate would be the exact opposite of what the United States seeks.

The discussion of exchange rate policy has generated substantial enmity in the NICs. By focusing narrowly on the exchange rate, the United States has polarized the issue unnecessarily. Rather, the exchange rate issue should be put in the context of broader discussions of NIC macroeconomic and adjustment policy. Such a framework would provide opportunities for the United States to advocate *mutual* adjustment beneficial to both parties.

Conclusion
This paper has sought to make several points of policy significance. First, the NICs cannot be treated as a group. Except for the exchange rate issue and some relatively minor intellectual property issues, there is little to negotiate with either

¹⁸ Jeffrey A. Frankel, *The Yen/Dollar Agreement: Liberalizing Japanese Capital Markets* (Washington: Institute for International Economics, 1984).

Hong Kong or Singapore. Both city-states are open to trade, welcome foreign investment and have achieved their export success through generally liberal policies.

The larger NICs, Korea and Taiwan, present different cases. Korea in particular has pursued export-led growth in a particularly mercantilist way, and has until recently maintained a number of restrictions on foreign investment. In general, the business-government relationship has been characterized by a high level of government discretion and intervention. Yet given the degree of intervention in the past, the accomplishments of the present reform effort should be recognized. In addition, many of the reforms that the U.S. is seeking are already supported by liberals within the bureaucracy and recognized by important segments of the domestic business community; the issue is one of bureaucratic resistance at lower levels and broader political opposition.

The challenge for American policy is therefore to encourage the reform process without generating a backlash that will either make that process more difficult or sour overall relations. There are several possible ways of accomplishing this. One is to make greater use of the Uruguay Round process. In recent years, U.S. trade policy with the NICs has moved in bilateral direction. Bilateralism has important political disadvantages. Where policy reforms are seen to stem from U.S. pressure, they can easily become the target of nationalist resistance even where they are in the interest of the country itself. The multilateral process is one way to encourage the NICs to graduate. At present, Taiwan is excluded from the GATT but the time may be at hand when serious consideration can be given to supporting Taiwan's entry.

Second, bilateral negotiations could be conducted more effectively. At present, the agenda is frequently set by short-term business interests. Such sectoral interests are important; they are the stuff of foreign trade and investment. At the same time, however, they can distract attention from longer-term interests and result in a focus on issues such as agriculture that are politically counterproductive. We should move toward a broader economic dialogue with the NICs that would parallel our discussions with the members of the Group of Seven. Such a dialogue would address the broader direction of economic policy, and serve to integrate trade, investment and macroeconomic policy discussions. It would also force the United States to address a difficult, but still unanswered question: in demanding "reciprocity" from the NICs, what is the United States willing to concede in return?

Mr. CRONIN. Let's turn right now to our first discussant, Tony Albrecht. Mr. Albrecht is a long-time career Foreign Service Officer; most recently he served as Deputy Assistant Secretary for Economic Affairs in the East Asian Bureau, Department of State. He has worked on economic affairs through much of his career. Since retiring in 1984, he has been Chairman of Corporate Programs for the Asia Society, Washington Center, and he's also the president of his own consulting business cooperation, Albrecht, Inc. Mr. Albrecht, please.

STATEMENT OF ANTHONY ALBRECHT, CHAIRMAN, ASIA SOCIETY CORPORATE PROGRAMS, WASHINGTON CENTER

Mr. ALBRECHT. Thank you. Well, first I would agree with most of your conclusions—in fact, all of them—the ones you just gave at the end. I'd like to introduce just a few numbers, because they're significant in terms of what's been said this morning about the problems that the U.S. faces; the difficulties of the adjustment process; the role of the NIC's, and so forth. And these are the figures for January to April 1988. We have a situation with the four NIC's in which U.S. exports to Singapore are up 33 percent; South Korea, up 40 percent; Taiwan, includes gold, I imagine, 197 percent, and Hong Kong, 33 percent. Now you can say, that's fine. The exports are going up, but some will say that imports are still surging and we're in a terrible state. The same figures for imports are as follows: we're at a standoff with Singapore at 33 percent, South Korea, 22 percent, Taiwan, 3 percent, and Hong Kong, 3 percent.

So that you have different positions. Just to take Taiwan, for example—the projection would be that the deficit with Taiwan will be cut from \$19 billion in 1987 to a little less than \$10 billion in 1988. The point is that these figures show change. One may ask whether it's a question of exchange rate or whether it's a question of the market opening measures. I would say it's a combination of the two. I would say in the case of Taiwan, that the market opening measures are having an effect that is showing up in actual trade figures. Korea may be lagging a little bit. And of course, you see a situation, certainly in the case of Taiwan and Hong Kong, where imports have very, very modest, almost no growth. So those are some facts to keep in mind, that might suggest that the adjustment process is moving along.

Now as far as U.S. policy is concerned, the notion of the NIC's started to be used maybe 5, 10 years ago and more recently, it's concentrated on the four Tigers. I would like to bring it up to date in terms of the debate in the OECD on what kind of language there would be in the ministerial communique. There was a fierce debate in Washington policy circles just prior to the OECD ministerial as to whether we were going to name countries, and it was decided that this was probably not a good idea because in the end, if you name countries, you're really just going to be pointing the finger at Korea, and maybe that's not a good thing to do. And somewhere along the line Brazil, Mexico, and other competitive countries that used to be called NIC's have been dropped out of this. So the NIC's concept has boiled down to really talking about the Asian NIC's and the fact that they are not cooperating in the adjustment process that the OECD would like to pursue, and in particular, that the Treasury Department would like to pursue. So what has happened is the United States, and in particular the Treasury Department is seen as the one who is putting pressure on Korea to appreciate the won and to some extent, on Taiwan to appreciate its dollar. Singapore and Hong Kong are just window-dressing. It's the same kind of window-dressing that was used with the Treasury decision with GSP—that you take it away from all four of them. You don't really want to do anything to Hong Kong and Singapore because they have basic free trade regimes, but politically, you've got to package it. So you have essentially the same kind of thing. Now there're consequences to this, namely, that there is a certain resentment at being singled out because all of these facts and ideas percolate very quickly to the Asian NIC's concerned. In a way it reinforces the notion that's already been brought out—that these countries are very different and our policy requirements and desires with each are very different. But they are being lumped together. I think if nothing else emerges from this discussion of the NIC's, it should be this—let's drop this business of the NIC's and concentrate on the individual countries. It's very confusing and it creates resentment. It also creates a sort of a policy momentum where we get into arguments with Hong Kong and Singapore about their responsibilities, which they tend to resent even more.

That brings us to the question of leverage. Certainly we have leverage with the Koreans, as was just brought out. The Koreans have a certain point—they're faced with the pressure to open their markets and to appreciate the won. Well, if you ask them to do two

things or ask anybody in a negotiation to do two things, he gets a choice. If the big Korean companies are faced with that choice, obviously liberalization of the market is a lot better than having a strong won that's going to undermine their position in international markets generally. You have a situation where in fact the Koreans are doing a bit of both. I think it's important to keep in mind that we've reached a degree of sophistication in all our negotiations with Japan, and now with Korea, and the other countries where we are engaged in political balance. What is the political balance? And I think these countries recognize that changing the trade balance, even improving it, doesn't do all that much good for these countries with the United States. In other words, the real pressure in the Congress for protection comes from specific interests that have specific problems. So in the Japanese case after tremendous pressure and effort, they will give in and try to appease a certain group. I think the Koreans and the Taiwanese also see that this is an appropriate way to deal with our pressures. And in the end, it's not a bad way for us to do it, because what we are responding to rather than theoretical or bureaucratic imperatives, are the demands of actual American companies that could make money in these markets. If we can satisfy those demands, and they can produce more and sell more and hire more people, that after all is the practical result that we want—not some vague economic, theoretical notion. So in political terms, I think there's a high degree of sophistication in our relationships with the NIC's.

Now, just quickly—one question that comes up is where does Japan fit into this. And I think that with the NIC's we are in a better position with the four Tigers than is Japan. Our bilateral relations are strong; the bilateral trade and business relations and investment relations are strong; and all of those countries care about their relationship with the United States. Because of the size of our market and their interest in our market, we have some pretty good leverage there. We are not providing aid to these countries. Now when you get to Southeast Asia, here the Japanese are in a very strong position—money talks. The Japanese have the money and we are in a very difficult situation because of our budgetary constraints in terms of giving aid, military assistance, all those things—the Japanese are in a very favorable position. They can bring in investment. It has already been pointed out that they bring a little leverage along with that investment, and certainly with all the aid they're giving, they get leverage out of that. So I say that as far as the Asian NIC's are concerned, with the big four we are in a fairly good bargaining position. This raises the obvious question, are there going to be other NIC's coming along? And the short answer is yes. But again I would prefer—I really think it's important that we deal with these as individual countries. We look at U.S. interest with those countries and pursue them rather than getting all tangled up in this business of NIC's as a group. I think I've spoken enough. Thank you.

Mr. CRONIN. Thank you, Tony. Our next discussant is Ralph Clough. Ralph is also a former long-time Foreign Service Officer, with a career centered on China, Taiwan, and Korea. He has been a resident scholar at both the Brookings Institution and The Woodrow Wilson Center and has written widely on East Asian issues.

Currently, Dr. Clough is professional lecturer and coordinator of the China Forum at John's Hopkins (SAIS).

Mr. Clough, please.

**STATEMENT OF RALPH CLOUGH, COORDINATOR, CHINA FORUM,
JOHNS HOPKINS UNIVERSITY (SAIS)**

Mr. CLOUGH. Thank you. I'd like to make one general comment growing out of this discussion and then focus the rest of my comments on Korea and Taiwan.

The general comment is that, as was remarked earlier in the day, the United States has become the world's largest debtor and Japan has become the world's largest creditor. This has obvious economic consequences but it also has political consequences that you notice when you travel around East Asia. And that is that there is a growing impression among the East Asians that the United States is in a state of decline. They see our influence as declining. And this is beginning to have some effect, I think, on our actual influence in that part of the world. One of the resulting problems was brought up just now, that is, the need in dealing with countries like Korea and Taiwan for broad policy discussions, not simply focusing on particular products, particular exports, particular issues. I find when I try to talk with people in Taiwan and Korea about the general problem of the United States, what we're obviously going to have to do—we're going to have to get our deficit down. This is going to have repercussions on them. I find them very reluctant to face up to that. They think somehow they can escape the effects of this inevitable development. And that's why I believe it's very important to get them into these broad discussions of macroeconomic problems.

Turning to South Korea and Taiwan, here you have two authoritarian systems which in the past have had a single powerful leader, and now they're giving way to a more liberal, more pluralistic system with a kind of collective leadership. The result of this, as has been mentioned, is that the governments are coming under more pressures from societies that are becoming more pluralistic. Interest groups are developing which have more leverage, more clout with the government, which makes it more difficult for the government to do the kinds of things which those governments have done in the past. The adjustment to this new situation is in part a generational change. Some of the new leaders coming on think rather differently from their seniors, and it's this younger generation which tends to demand more rapid change. The older generation resists it. Yet in both South Korea and Taiwan you have a great need for structural change—political structural change.

For example, the role of the legislature in both Korea and Taiwan is becoming more important. Legislative politics is coming into its own, not just in terms of fist fights on the floor of the legislature in Taipei, but in more essential ways. In Taiwan they have a special and very difficult constitutional and political problem of replacing the aging legislators who were elected on the mainland in the 1940s with young people who will be elected from the constituencies in Taiwan. In Korea you have a need to institute a system of

elective local and provincial governments. Korea is one of the most highly centralized systems in the world, where all officials, right down to the cities and towns, are appointed by the central government. The Roh Tae Woo government is committed to begin the process of establishing local autonomy, as they call it, next year, but it will be difficult and probably slow. In Taiwan you need to separate more clearly the role of the KMT, the ruling party, and the role of government. In the past, in many areas the party role and the government role have been blurred, but with an opposition party now—one significant opposition party—(a number of others having been formed) the KMT is going to be under a lot of pressure to give up some of the quasi-governmental functions it has had in the past. I don't think this is quite giving up the reins as Stephan Haggard said, but loosening the reins.

Now let me turn more to Korea—not just South Korea, but both Koreas, because Korea is an area where probably the least change has occurred in some respects—less change than other parts of East Asia. It seems to me that sometime before the year 2000 the confrontation between North and South Korea, which has been frozen for 35 years in a kind of anachronistic cold war confrontation, is going to see some important changes. Two huge military forces are facing each other across the DMZ. There's no dialogue going on at present between North and South. There's no travel. There's no trade. Not even an exchange of mail between North and South. I think this is bound to change. Today there is an unprecedented debate on unification going on in South Korea. Roh Tae Woo has committed himself to new initiatives on dialogue with the North, and I think some movement on this front is likely to occur after the Olympics. But how much change will take place really depends on whether or not North Korea is prepared to soften the very rigid posture that it has maintained in the past whenever a dialogue has occurred.

Another area where there's going to be pressure for change is with respect to the U.S. force presence. We are now beginning to hear for the first time among some of the students in South Korea, calls for the withdrawal of U.S. forces. You didn't hear this in the past. It's not a powerful voice at the present time. Most Koreans don't want U.S. forces to withdraw, but South Korean military leaders have predicted that by the late 1990s they will have parity with North Korean forces in terms of military equipment. A broader range of South Koreans than the radical students are beginning to talk about the need to shift the operational control of U.S. and Korean forces in Korea away from the U.S. commander to a Korean commander, since, after all, the Koreans have the great majority of forces there. This creates various problems.

There is also a transition almost certain to come in North Korea. North Korea has been, except for Albania, the most laggard of the communist countries in deciding that they need to reform their economic system. They have a very sluggish economy, very closed to the outside. They have talked about expanding foreign trade, but they haven't had much success at it because they don't know how to go about it, and it's really very difficult to do under the tight controls of the totalitarian system which Kim Il Sung has enforced. He's 77 years old and preparations are underway for his son to suc-

ceed him. Whether his son will make any radical changes in the system remains to be seen. Whether he can even maintain himself in power after his father is gone is uncertain. But I think the pressures for some rather radical changes in North Korea are going to grow. The changes may not occur until after Kim Il Sung is gone, but they will occur.

The other important development that has already been mentioned, is the increase in contacts and trade between South Korea and China, and to a lesser extent, between South Korea and the Soviet Union. South Korea, the United States, and Japan have since 1973 argued in favor of cross-recognition, that is, having embassies from the four big powers in both Korean capitals instead of the present way of having the Japanese and the Americans with diplomatic relations only with South Korea, and the Chinese and the Russians with diplomatic relations only with North Korea. My conversations with Soviet and Chinese officials and scholars convinces me that they would be happy to go along with cross-recognition if North Korea would drop its objection. North Korea argues that cross-recognition would simply confirm and perpetuate the division of Korea and they oppose it. Whether or not cross-recognition will take place, the cross-contacts that are going on are bound to increase, it seems to me.

Now, what are the challenges for the United States? The first has been mentioned by several people and that is that obviously we have to put our own economic house in order. We have to counter the growing view that the United States is in a decline, unable to cope with its own financial difficulties, dependent on foreign capital. We also have to, I think, work more effectively with those politicians and bureaucrats in Japan, Korea, and Taiwan who recognize that in their own interests they must open their markets more. And we must also, in doing this, collaborate more effectively to educate people in those countries of the importance of working together—their working together with the United States to solve trade disputes. Too often, it seems to me, trade disputes get treated in a very emotional way in the press of South Korea or Taiwan or Japan, and there's a great need for cooling the atmosphere and dealing with these things in terms of national interest, showing where national interests clash and where national interests coincide.

One final comment with respect to South Korea. I agree very much with the comment that anti-Americanism in South Korea is on the rise, and it's here where our security interests and our economic interests are both affected, because there are different causes for anti-Americanism in South Korea. The students argue that the United States is responsible for the division of Korea. We have troops in Korea, therefore, we must take an initiative. We must take responsibility, as they put it, for bringing about the unification of Korea. With respect to the businessmen, of course they have different reasons for criticism of the United States, that is, our trade policy and the pressure they feel we're putting on a small country—a huge colossus of a country, as they see us, beating on this small country, trying to get them to open their market. This leads to a rising anti-Americanism, and I'm afraid it's going to

continue for some time, and that we will have to find ways of living with and managing it. Thank you.

Mr. CRONIN. We will now open the panel for questions and comments. Kent Calder has his hand up first.

Mr. CALDER. Just a very quick question that relates to Tony Albrecht's remarks about dropping the concept of the NIC's. I can certainly see for analytical purposes in terms of what you said and Stephan Haggard said that it would be sensible. But I wonder if the current turbulent political situation in Korea and Taiwan doesn't dictate a tactical approach which avoids singling out those particular countries?

Mr. ALBRECHT. I guess I would stick to my guns. The situation we have with Korea is so important and so serious that I don't think lumping them with the NIC's is worth either the kind of frustration and resentment that it breeds in Hong Kong and Singapore or the kind of spillover in attitudes within the Washington scene where the NIC's are seen as bad, the four Tigers, the four Dragons, all that kind of thing. So I don't think there's enough to gain from that to preserve the NIC's as a concept. I think just the notion of the OECD discussions fits into what you said about the need for this broader dialogue. We do have the broader dialogue in the U.S.-Korea consultations. That gives an opportunity to Undersecretary Wallace. He goes to all the OECD meetings and he'll be talking to the Koreans. Now hopefully—and this is a challenge for U.S. policymakers—we can have a more balanced approach toward this in which we are truly seeking Korean cooperation in the world economy, and the Koreans will see some benefits to cooperation in an OECD context and in an economic policy dialogue, and not feel that this is just a device that we dreamed up to put pressure on won appreciation.

Mr. BENNETT. Let me make a couple of points. One is that we have been talking with the Koreans on market opening, and economic restructuring at least since 1975, because that's when I started doing it. It may have been going on earlier than that. The economic people that I know were pretty well persuaded—in fact they have been pretty well persuaded all along. The problem is the political problem—the particular individuals and companies who were going to get hurt. They were able to slow the adjustment process down or stop it.

Now the interesting thing is that we are observing an alternative to market opening and exchange rate changes: wages go up, and this is what accounts for Hong Kong's recent decline in its current account performance. If you run an economy on the basis of enormous exports and very little imports, it puts pressure on the labor supply and this is also what's now happening in Korea. The market is validating the trade union demands for higher wages. If it somehow hasn't gotten through to the entrepreneurs and other groups, that there's no free lunch in economics, so they continue to oppose reevaluation. Markets do operate and are operating in Korea and whether they have the trade unions or not, you would probably have had wage rises. The late-Park period was also a period of very rapid wage rises because of pressure on the labor market. Unemployment is now down below 3 percent in manufacturing. It has been for over a year. That's sort of a threshold for

Korea for inflationary wage increases. But I think you're going to find such wage increases will occur in other countries as well as under similar circumstances.

It reminds me however of another point—I go back to why the Korean authorities have not responded to the overall adjustment problem and the pressures we put on them on exchange rates and market openings, recognizing that there was a future problem coming in any case. It seems to me it's not just the prisoner dilemma. It's a calculated response—the U.S. hasn't taken the complementary steps it needs to take to reduce its trade deficit. The market pressures have not begun to work on Korea and the other countries, so why should they respond now. If they cut their exports, and their current account surplus, all it means is that somebody else's current account surplus with the U.S. is going to go up. Why should they give that up until the U.S. begins to make the responses needed to cut its trade deficit.

I think the most troublesome area in Korea and it's going to be with other countries as well, is agricultural adjustment. The politics of that are very difficult. And it bothers me that the U.S. puts so much emphasis on it. Korea still has about 20 percent of its labor force dependent on agriculture. And it's going to be another generation before the agricultural labor force is reduced greatly. They don't have alternative employment. They are by and large older people. They don't have skills or experience that are transferable. They're going to stay in farming. Agricultural protection becomes a way of income transfers from the urban sector to the rural sector. You can do it other ways—with income transfers—but they will continue to produce. There are some things that would improve Korean agriculture. For example, they should get out of producing bananas at a buck apiece. And a whole series of things like this—and greater reliance on market forces could play a much more important role in agriculture, but the U.S. is attacking this problem in a way that is not going to be helpful and it's going to run right across the grain—the universal belief among Koreans that they've got to do something to keep their agricultural people reasonably well off.

Mr. CRONIN. Thank you, John. Mike Bennefiell from the Commerce Department is next.

Mr. BENNEFIELL. I address my question to Tony Albrecht. I have some confusion at this point about what the aims of our broader economic discussions with Korea on our macroeconomic agenda are, if they are not designed to give the Koreans a rationale for import liberalization and for currency appreciation. It seems to me that this morning's program suggests that we in the United States have to put our macroeconomic accounts in order. We are on the eve of making a shift of something on the order of \$250 billion to order to bring our global trade deficit down to about \$50 billion. Somebody has to pick up that slack if global trade is to expand or to stabilize at current levels. So are you recommending those broader economic discussions not to accomplish that or to accomplish that? And what is Korea's role? What do we expect of them?

Mr. ALBRECHT. I would say that one way to pose it would be to say to the Koreans, look, as you say, there's going to be this big adjustment. Now there are two sides to this. Would you like us to control

imports or might it not be better for us to correct the problem by continuing the surge in American exports to Korea. Doesn't that make a lot more sense for Korea's development in terms of controlling inflation, in terms of making sure that Korea continues to grow as a competitive power in the world economy than protecting its markets and becoming weak. So certainly the liberalization argument is very good. Now the won appreciation agreement is also one to be made, and will be made, I'm sure, because you can make some arguments to the Koreans as to why certain aspects of won appreciation might be helpful to the Koreans in their current and future economic development. You can make some economic arguments. But how well they will respond will be just like how well we could respond to those questions. It will depend on the political forces. And I think that a very key point that's been brought out this morning is we now have a different situation in Korea.

And so we are going to pay the price of democracy and the Koreans are going to be as screwed up as we are when it comes to making good clear, crisp economic decisions. Now that may affect their growth a little bit. It may slow it down a little bit, but I don't think they're going to move that quickly toward American-style democracy even though there is some movement in that direction. Nonetheless it's going to complicate the American negotiators' position. Because using the security argument which was always the club we had behind our back, even that is more difficult now with all this sensitivity to the U.S. military role. So it's a new ballgame, and I think in that context we will find, as we have already found very good cooperation from the Roh government in terms of trying to solve some of these very nasty problems. We have made some progress on the negotiations. So I think they will be trying to do whatever they can for us which they can also defend as making sense in Korea's interests. So I'm not negative on the prospects. I think we should treat it in terms of the world economy and the U.S. situation in the world economy, and Korea's situation. As a matter of fact, the agenda for these economic consultations always includes talks about the situation of the world economy and the two individual economies. So I think there's good potential in that.

Mr. CRONIN. Thank you. Are there any other comments? It appears that everyone is ready for lunch. My thanks to the panel and the rest of you for your comments.

[Lunch recess.]

PANEL 4.—JAPAN AS A SUPERPOWER: IMPLICATIONS FOR U.S. INTERESTS

DISCUSSION LEADERS:

Kent E. Calder, Woodrow Wilson School, Princeton University
 Ronald A. Morse, Development Officer, Library of Congress

COMMENTATORS:

Ira Wolf, Legislative Assistant, Office of Senator John D. Rockefeller, IV
 Glen Fukushima, Deputy Assistant Trade Representative for Japan and China,
 Office of the U.S. Trade Representative

MODERATOR: Dick Nanto, Specialist in Industry and Trade, Congressional Research Service

Mr. NANTO. The title of this session is "Japan as a Superpower: Implications for U.S. Interests." We are fortunate in having today

two outstanding individuals who will lead the discussion. The first is Kent Calder, who teaches at the Woodrow Wilson School of Public and International Affairs at Princeton. He's the author of a book *Crisis in Compensation, Public Policy, and Political Stability in Japan, 1949 to 1986*. He also is the co-author of *The Eastasia Edge* a book most of us have read. Before teaching at Princeton, he served as the first executive director of Harvard University's program on U.S.-Japan relations.

Following Dr. Calder's presentation, we will hear from Ronald Morse, who currently serves as the Development Officer of the Library of Congress. He comes to the Library from the Woodrow Wilson International Center for Scholars where he served as assistant director for development and as secretary of the Asian Program. Ron has a Ph.D. from Princeton and has worked at the Department of Energy, Department of State, and Department of Defense. He's edited more than a dozen books on Asian cultural and political issues and his most recent article, "Japan's Drive to Pre-Eminence," was published in the winter (1987-88) issue of *Foreign Policy*.

We are also fortunate in having two outstanding discussants. The first is Ira Wolf, who is legislative assistant to Senator John D. Rockefeller. Ira comes from the State Department. He was a foreign service officer and served two tours of duty in Tokyo. He was also Chief of the Textiles Division at the Department of State.

Our second discussant is Glen Fukushima. Glen is Deputy Assistant to the U.S. Trade Representative for Japan and China. He is in the Executive Office of the President and works on trade problems with these countries. Until June 1988 he was Director for Japanese Affairs at the USTR. He is the chairman of the Trade Policy Staff Subcommittee on Japan, so he's the one who directs much of the trade policy formulation on Japan. He has attended Kyoto University and has a law degree from Harvard. In addition, he has also attended the Harvard Business School.

We will start with presentations of about 15 minutes from each of the discussion leaders beginning with Dr. Calder.

STATEMENT OF KENT E. CALDER, WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY

Mr. CALDER. I don't think there's any need to belabor the changes in the global political economy over the last few years, particularly since the Plaza agreement and related currency realignments and the way those realignments and associated capital outflows from Japan have magnified the economic role of Japan in the international system. We've seen a sharp shift in Japan's credit position from debtor until the mid-1980s to a creditor with net assets overseas of \$241 billion at the end of 1987.

Now what I would like to do today is to ask whether this transformation which we've seen in Japan's international position—the very rapid rise in capital outflows since 1982 into portfolio investment, the rapid rise of Japanese direct foreign investment, and some of the associated changes that have occurred as a result of the steady yen reevaluation that we've seen—are inimical to U.S. interests or complementary to U.S. interests.

The first basic point that I would want to make relates to Japanese domestic political and economic structure. We've talked a lot about the international system and how it's changing. How Japan will respond to the pressures that are on it for a larger global role, of course, depends profoundly on the character of the Japanese domestic system and how that is changing. Ron will be talking about the individuals—prime ministers and so on, and their different styles. I'd like to look more at the governmental structure and the interest group structure, and what implications changes in those areas have for the kind of role Japan can play in the international system.

I have a piece in the July issue of *World Politics* about Japan as a reactive state, and the reasons why it has that particular character. A reactive state, I believe, has two basic characteristics. One is that it's not easily proactive in the international system—that is to say, it can't easily come up with major international initiatives. The other aspect is that under pressure, particularly given the way Japan has integrated into the international system, you do see a substantial degree of pragmatism and grudging flexibility.

There are several reasons why this is true. The lack of a strong executive, for example, in strong contrast to the U.S. and France, is one major reason Japan finds it difficult to put together sweeping sorts of initiatives. Another has to do with the rising role of the Liberal Democratic Party in the policy process just as it becomes more expected of Japan to undertake major initiatives. The LDP finds it difficult to come up with those initiatives. Also interest group structure within Japan is another important thing. Japan doesn't have the large groups of immigrants which in Germany or here in the United States have made the domestic political process quite sensitive to international issues. There isn't really anyone with strong international ties except for about 600,000 Koreans. Also the interest group structure—Japan's relationship to the world has been very heavily dependent on exports, particularly to the market where the possibilities were quite clear. It wasn't necessary to get too deeply involved in politics, and take one stance or another in Japanese domestic politics regarding trade policy, because it was pretty clear as to how things would evolve. In other words, Japanese could tolerate Japan being a reactive state without losing anything basic.

I might add that the rising credit position of Japan also makes it relatively conservative in its conception of how the international system should be structured. Because of this huge creditor position, Japan is intent on preserving the status quo and desires to see rules on investment behavior for the system as a whole sustained. It is also interested in stable exchange rates. Given this huge credit position that Japan has, the exchange rate in particular becomes extremely important. So Japan is a reactive state, a conservative state, whose interests will be increasingly conservative as long as there aren't major shocks.

This brings me to the forces that I think could conceivably transform Japan's international role and present more direct complications for U.S. interests. As long as one were not to see, either in the financial markets or probably in the energy markets, extreme shocks which cut in ways adverse to Japanese interests, you would

find Japan largely a supporter of the basic status quo that we have. Japan has been contributing more to multilateral institutions recently, especially in backing for special facilities. For example, there's a new World Bank facility for multilateral investment guarantees in Third World nations. Since the United States hasn't wanted to allow the voting rights in some of the major entities like the IMF and the World Bank to shift to other nations, Japan has set up a series of these special facilities to play a more active role. But basically I think these have been consistent with U.S. interests in a stable system.

The threats come through instability in the international system as Japan's basic relationship to it changes. Japan has thus far been an export-oriented nation. As such, it didn't have to be too concerned with how the threats of nationalization, investment policies overseas of various nations, tax policies, this and that. Exporting was a relatively simple business. Now Japan is moving toward heavy investment commitments overseas. And once again, as long as the parameters are stable, I don't think that presents a likelihood of aggressive Japanese actions contrary to U.S. interests.

If you were to get a major energy shock of some sort, I think the major implication of that would be deflationary for the major industrialized economies—greater unemployment here in the United States, and probably greater unemployment in Japan. Such a shock might or might not be offset by an expansion of demand in some of the oil-producing nations. But it would be deflationary here, in the initial stages. It would cause unemployment. It might affect the patterns of Japanese investment in the U.S. which we've seen beginning to grow, which thus far have been stabilizing the trans-Pacific economy both economically and politically. An energy shock would also put the U.S. and Japan who are the two largest consumers of energy in the world—together consuming approximately 40 percent of all the imported oil that travels in international trade—in more direct competition with one another. It would also likely give the production capabilities of the Soviet Union and China, more importance as a lever against Japan. Broadly speaking, I think a major oil shock could have significant negative consequences for U.S.-Japan relations, although it is not likely in the short run.

The other development that I think could be destabilizing would be major instability in global financial markets. The Brady Commission, of course, has suggested that the shock last October was significantly related to the rise in interest rates in Japan that preceded it. So in a sense the lack of coordination on that issue between the U.S. and Japan may have been a major factor. Fortunately, we had coordinated reflationary policies afterwards among the major governments that prevented a sharp deflationary effect from developing, but if one were to see significant financial turmoil, again I think that could also set some highly negative forces in motion.

Broadly, the U.S.-Japan relationship, is tremendously important for Japan. Thirty-nine percent of Japan's exports go to the United States. The share of profitability for Japanese firms from exports to the U.S., particularly until 1985, was sharply higher than and still continues to be greater than the profitability of most other

export markets, particularly some of the East bloc alternatives where Japan traditionally has been selling at very low prices. So this importance economically of the U.S. market for Japan, I think, ties Japan in a very fundamental way, very tightly to the United States in the short run, particularly given its reactive political structure. In the absence of these large energy or financial shocks that I'm talking about, I tend to think that the alternative of substantial realignment away from something that the United States felt strongly about is probably infeasible for Japan. In the longer run, if Japan does begin to see perestroika succeeding, or significant economic development in China, those continental economies, become more attractive, particularly in a high-cost energy or high-cost raw materials environment. But personally I suspect that at least in a 5- to 10-year time frame, China and the USSR can in no sense rival the economic attractions of the U.S. market. There are few Japanese industries that are highly reliant on these East bloc markets. In steel, for example, 21 percent of Japan's exports go to China. The U.S. is number two at 16 percent; the Soviet Union, third, at 9 percent. But steel is a real anomaly, and even there the profitability of East bloc markets is not so significant.

So the final picture that I think one is left with is of a Japan that certainly is rising economically in importance, but which is tied very deeply into a broader structure of political and economic relations of which the United States is the linch pin. Both because of its domestic political structure and also its overriding international economic interest in the U.S. market as compared to others, Japan is unlikely to be able to shift over the next 10 years toward an active anti-American stance even should anti-U.S. sentiment grow much stronger than I anticipate.

Mr. NANTO. Thank you Kent. Your prepared statement will be inserted in the record.

[The prepared statement follows:]

PREPARED STATEMENT OF KENT E. CALDER, WOODROW WILSON SCHOOL, PRINCETON UNIVERSITY

JAPAN AS AN ECONOMIC SUPERPOWER: IMPLICATIONS FOR U.S. INTERESTS

Japan's rapid rise to international economic prominence has been one of the central developments of the past generation—indeed, the past decade—in world affairs. Two decades ago Japanese GNP comprised less than 5 percent of the global total; that share now well exceeds 10 percent. Two decades ago Japan's merchandise trade balance was still perennially in deficit; today, its current account surplus runs around \$80 billion a year. Persistent trade surpluses across the 1970s and 1980s have propelled the value of the yen against the dollar to nearly three times its level of 1970, leveraging Japan's ability to deploy its huge domestic savings for broader global purposes.

Many ask whether it is not now Japan's turn to assume a more active role in ordering the global trade and financial systems, while also shouldering greater expanded foreign aid or defense responsibilities. With net foreign assets of \$241 billion at the end of 1987, and persistent current account surpluses of \$80 billion annually, Japan has been experiencing capital outflows half again as large as those of all the OPEC nations combined at the height of their wealth. By 1990, with external assets which many forecasts suggest may exceed \$500 billion, Japan will be approaching a scale of international wealth, relative to its partners in the international system, rivaled only by the United States in the late 1940s or Victorian Britain in 1900.

The United States has been actively pressing for an expanded Japanese international economic role for decades, being instrumental in securing Japan's admission to the IMF (1952), World Bank (1952), GATT (1955), and the OECD (1964). Over the

two decades since its full admission to the community of industrialized nations, Japan has slowly built up credibility at the international economic institutions, as at the United Nations, through increasing financial support and consistent diplomatic backing for the principle of multilateralism. But there have been few independent Japanese initiatives forthcoming, either in the multilaterals or elsewhere. In the absence of foreign pressure Japan has rarely acted; Japan's international economic diplomacy has by and large been that of a "reactive state."

The Changing Nature of Japan's External Economic Commitments

Japan's economy is in the midst of a fundamental transformation in its relationship to the broader world which is gradually intensifying domestic pressures within Japan for greater activism on global financial and, to a lesser degree, investment and trade issues. Most fundamentally, there has been a sharp increase over the past three years in Japan's external assets, coupled with rising instability in international exchange rates—a dual shift unprecedented for Japan, both quantitatively and qualitatively. In 1980 new Japanese direct foreign investment totalled \$4.7 billion; this rose to \$12.2 billion in 1985, but then by quantum magnitudes to \$22.3 billion in 1986, and to roughly \$34 billion in 1987. Well over a third of new direct investment was in the United States. Japan's portfolio investments rose almost \$40 billion in the single year of 1986, to \$110 billion, and by a significant amount during 1987 as well, although the rate of increase declined due to exchange-rate economic pressures on Japan for policy activism. These pressures have been made particularly acute by the rising turbulence in global currency and financial markets since October, 1987. As long as the United States was a major international creditor, it had a vested interest in currency stability and activism in international financial affairs upon which Japan could rely, making Japanese activism less necessary. But as Japan itself becomes overwhelmingly the largest global creditor, and the United States the direct beneficiary of persistent depreciation in the yen value of Japan's huge U.S. dollar holdings, U.S. incentives begin to change, in ways not clearly congruent with Japanese interests. Steady devaluation of Japan's dollar assets thus stimulates Japan toward new activism in international monetary affairs.

Obstacles to a Japanese Global Leadership Role

Stability in the international economy, many analysts have argued, requires one nation to serve as a stabilizing power. Such a stabilizer makes and enforces rules of the economic system, provides a key currency, and also, in a liberal economic system, supplies a relatively open market of last resort—preeminently, in the current context, for the exports of developing nations. Despite Japan's rising economic wealth, the Japanese political economy appears structurally incapable in the foreseeable future of playing all these roles simultaneously, in the comprehensive way that the United States has assumed them since World War II. While Japan's defense spending is much higher in quantitative terms than often recognized (third largest in the world by NATO's definition, at end of 1987 exchange rates), Japan lacks the vital ability to project its military strength internationally. Such ability has been characteristic of all past hegemonic powers, and an implicit sanction behind their rule-making and enforcing authority. Japan is strongly impeded by both domestic and foreign opposition to rearmament from developing that sort of military capacity. Cultural factors, particularly lack of a transcendent sense of national mission, also complicate Japan's emergence as a dominant world power.

Most importantly, important domestic structural constraints persist, which limit Japan's emerging global role and render it almost invariably reactive. The fragmented character of state authority in Japan makes decisive action much more difficult than in nations with strong chief executives, such as the United States or Fifth Republic France. The problem of domestic coordination is compounded in Japan by the lack of either a functionally oriented administrative corps, like that of France, or authoritative codification of ministerial responsibilities to dampen bureaucratic disputes over jurisdiction. Japan has a hierarchy, or complex of overlapping hierarchies, in its administrative structure, but only weak central coordinating authority.

To be sure, Japan has powerful national ministries such as MITI and the Ministry of Finance, together with an experienced diplomatic corps. These lend an aspect of decisiveness to policy on narrow technical issues within their clear individual areas of technical expertise and established professional concern, such as technical standards for the consumer electronics industry, or the establishment of research cartels in integrated circuits. Japan's elite bureaucracy will no doubt be the chief architects of their nation's expanding global role. But on broad, complex questions of global economic management, or on issues created by emerging technology or economic transformation where bureaucratic responsibilities have yet to be defined, ministeri-

al jurisdiction is often unclear and internal conflict within Japan over how to proceed is often strong. In such cases, of which many trade and some financial issues in the 1980s are clear manifestations, Japanese policies can hardly avoid being reactive.

The rising role of Japan's ruling Liberal Democratic Party in some, although by no means all, aspects of Japanese policymaking also complicates emergence of a decisive Japanese global role. LDP politicians are, as individuals, often more decisively pragmatic, and more willing to take bold international steps than their bureaucratic counterparts, as the initiatives of former Prime Minister Nakasone Yasuhiro in summit diplomacy and U.S.-Japan relations vividly demonstrate. Some Opposition politicians have also at times shown vision in international affairs. But the deep factional structure of the major Japanese political parties and the salience of grass-roots pressures in their calculations—a salience enhanced by Japan's multi-member district electoral system—make the parties, including the LDP, slow to act on foreign policy matters. These traits also give Japanese political party behavior in the international arena a low-profile, distribution-oriented cast. The LDP, for example, has been heavily involved in government decisions on international airline routing. Individual politicians have also mediated major trans-Pacific investment projects, and significantly encouraged the increasing activism of U.S. state governments in trans-Pacific relations. All these low-profile steps are undoubtedly more productive for Japan in defusing the prospects of large-scale protectionism in the West, and in stabilizing the fabric of international trade and investment, than often realized. But they do not propel Japan into a global leadership role.

The domestic constraints on a Japanese coordinating role in the global economy appear most clearly with respect to international trade. Japan has lent important diplomatic support to multilateralism over the years, through backing for institutions like GATT and the OECD, as well as support for new multilateral initiatives such as the Kennedy, Tokyo, and Uruguay rounds of trade negotiations. Japan's overall tariff levels on manufactured goods are lower than in either the European Community or the United States, and Japan uses quotas less extensively, outside agriculture, than most major industrialized nations. Even in agriculture important liberalization measures are underway, particularly on items of particular bilateral interest to the United States, such as processed food products.

But the central test of Japan's ability to fill a global leadership role with respect to trade is not pragmatic, case-by-case concessions on a bilateral basis, but an acceptance on a non-discriminatory basis of products from throughout the world, including the manufactured exports of developing nations. In 1985 the United States took around 64 percent of LDC manufactured exports to the advanced industrial world. Japan took 8 percent. Despite accelerated off-shore sourcing of components from Japanese subsidiaries in South Korea, Taiwan, and Southeast Asia during 1986-1987, to partially neutralize the effects of yen revaluation on Japanese domestic production costs, Third World manufactured imports into Japan have otherwise just begun to grow.

Although imports into Japan of processed raw materials and captive industrial components from the Third World will no doubt continue to increase, labor-intensive manufactured imports present Japan with a much more complex structural adjustment problem, due to the unusual dual structure of the Japanese economy. Seventy-four percent of Japanese manufacturing employment, and fifty-two of Japanese industrial production, is undertaken in small firms with under 500 employees—ratios half again as high as in the United States, Britain, or West Germany. The Japanese metal fabricating sector, with over 650,000 employees, has fifty percent more workers than the entire steel industry. Many of these labor-intensive sectors, such as metal fabrication and plywood, compete directly with prospective Third World imports, although not with products of the industrialized West. These sectors also have unusually strong ties with the Japanese political world; plywood, for example, is a prominent industry in Prime Minister Takeshita Noboru's home prefecture of Shimane, and he has actively backed its interests in the past.

Rationalization of Japan's highly inefficient distribution sector would also seem fundamental to Japan's emergence as an active mass importer. Yet this again is so seriously impeded by Japan's prevailing employment structure, and the natural support of vocal politicians for such a large constituency, that it cannot readily be changed. Distribution in 1984 constituted 23 percent of the entire Japanese labor force, compared to only 9 percent for agriculture; a large portion of those employees in distribution were redundant. Japan has roughly twice the number of retailers per capita of the United States, and fifty percent more than in any other major industrialized nation. Yet the 1973 Large Scale Retail Store Act seriously complicates rationalization, and modification of other existing obstacles will be very difficult politi-

cally in Japan, especially with unemployment steadily rising in other parts of the Japanese economy. In an era when traditionally traded sectors such as automobiles and auto parts are already being rapidly "hollowed out" by rising offshore investment due to yen revaluation, Japanese political leadership will be under strong domestic pressure to avoid the hegemonic role of "importer of last resort," especially with regard to labor-intensive Third World manufactures which compete with Japanese small business. For both political and strategic reasons—Japan remains, after all, highly dependent on imported raw materials, including oil, whose prices are volatile. Japan would strongly prefer to reduce its trade surpluses through export restraint, accelerated foreign investment, and expanded Third World loans, coupled with *ad hoc* bilateral concessions to the United States and the European Community, rather than through the wrenching structural adjustment which large-scale imports of LDC-produced manufactures would involve.

The specter of serious domestic unemployment, coupled with wrenching readjustment in Japan's unusual dual economic structure, thus stands as a fundamental obstacle to Japan's assumption of a comprehensive American-style leadership role in an open world economy. This reality need not, it should be stressed, seriously impede the emergence of a trans-Pacific economy linking Japan deeply with the United States, since our prospective trade is largely in agricultural products and capital intensive manufactures. It need not seriously disrupt U.S.-Japan bilateral relations, or impair strategic Japanese support for forthcoming Uruguay Round negotiations on agricultural and service trade. But the political and economic realities of Japan's dual economic structure do intensify the long-run complexities of maintaining multilateralism on a global basis, and arresting the gradual *de facto* shift toward a world of discriminatory trading blocs.

The Contours of Japan's Emerging Global Economic Role

The world economy, as it moves beyond the era of Pax Americana, clearly needs a stabilizer. Japanese corporations, as they become ever more multinational, increasingly share that functional need, which Japanese domestic political structure as presently constituted does not allow Japan to supply, and Japanese cultural values could not in any case easily sustain. Yet the likely outcome of this impasse is not inevitable chaos, despite the thorny issue of Third World manufactured imports considered above. Neither is a world of regional trading blocs likely; such blocs would serve neither the increasingly global interests of Japanese and Western multinationals, nor the national interests of many trading states.

Traditional Japanese domestic political support for multilateral institutions such as the United Nations and the GATT, combined with emerging economic interests of Japanese multinationals and Japan's continuing character as a "reactive state" in international affairs, suggest the strong prospect that support for existing multilateral institutions—will be a major aspect of Japan's emerging international role. Already 32 percent of Japanese foreign aid is channeled through multilateral institutions—substantially above the DAC average of 22.5 percent, and one of the highest levels in the OECD. Although Japanese have taken a relatively low profile at multilateral institutions—only the World Health Organization and the Asian Development Bank, for example, are headed by Japanese—they have provided rapidly increasing financial support which should become an increasing mainstay of the operations of such multilaterals. Due to differences with the United States and some of the European nations over Japanese voting rights—traditionally proportional to capital participation at many of the multilaterals—much of the expanded Japanese support may come through establishment under Japanese auspices of new special facilities of existing international agencies. The sheer scale of Japanese economic capabilities will also allow Japan to devote attention to some key bilateral relationships. Japan currently provides between one-half and two-thirds of all bilateral assistance to China, Thailand and the Philippines; such deep bilateral ties within the Pacific region may well intensify.

Within a global multilateral framework, any prospective Japanese leadership role in international economic affairs will likely be technical and sector-specific, rather than broadly political. Such a role will emerge most clearly in those areas such as energy and finance where bureaucratic jurisdiction is clear within Japan, and where the national strategic need for activism is evident. To the extent that Japan assumes a leading global role in these areas, however, the transition may be stormy and crisis-driven, as policy change in Japan frequently is. Japan will likely act in response to outside suggestion, only after others have proven unable or unwilling to do so.

In energy, Japan's continual concern must be neutralizing the vulnerabilities which heavy reliance on imports generates. In 1985 Japan imported 80.9 percent of

its oil-equivalent energy, compared to 50.3 percent for Germany, 15.8 percent for Britain, and only 9.8 percent for the United States. Only Italy, among the industrialized nations, faced comparable dependencies. Even following the oil price collapse of 1986, Japan had a trade deficit of around \$20 billion in petroleum—fifty percent greater than its iron and steel exports.

Japan has played an active role in the International Energy Agency since its inception. It has also given substantial attention to alternate energy. Should the prospects of major energy shortages once again appear imminent and pressure build for concerted action, Japan might well be willing to coordinate accelerated multilateral alternate energy development projects, and to support them financially.

Japan's capacity—and probably its incentives—to assume important stabilizing functions for the world economy as a whole appear strongest in the area of international finance, principally due to Japan's huge, and rapidly growing, international portfolio investment position. Although the yen is clearly not a preeminent global "key currency," its 7.6 percent share of official international foreign exchange holdings at the end of 1985 had risen by half since 1983. In both international securities underwriting and international lending, yen-denominated transactions had surpassed by a considerable margin those in sterling and Swiss francs by the early 1980s; in 1986 yen-denominated bond issues in the Euromarkets surpassed those in Deutschmarks for the first time. The role of yen in trade transactions is also expanding, with the share of Japanese exports denominated in yen having doubled since 1975. In official foreign exchange transactions, the financial authorities of the world, particularly in the United States, have also significantly increased their use of yen as an intervention currency.

Even more compelling than recent developments are prospective future trends, particularly if volatility in global exchange rates continues. For years, a significant barrier to yen internationalization was the weaknesses of Japanese financial markets, and the consequent illiquidity of yen-denominated assets. These obstacles are rapidly subsiding, as the range of financial instruments available in Tokyo steadily expands. Increased official and corporate holding of yen by non-Japanese is a likely result of Tokyo's emergence as a major financial center. Japan's persistent creditor status, reinforced by rising portfolio investment income conservatively expected to rise to \$50-\$60 billion (the scale of the 1987 U.S.-Japan trade imbalance) by the early 1990s, should accelerate the process of yen internationalization. The climactic step toward a key currency role for Japan could be the widespread issue of yen-denominated U.S. Treasury bonds, a step likely to be demanded with increasing fervor by Japanese institutional investors if stability does not come soon to global foreign exchange markets.

Among the most notable Japanese initiatives in global finance thus far have been those strengthening multilateral mechanisms for encouraging the flow of private capital to developing nations, a trend which may well intensify. In June, 1987, for example, Japan became the first industrialized nation to ratify the convention establishing the Multilateral Investment Guarantee Agency (MGIT). Japan has also become an increasingly prominent financial support of multilateral development banks, including the Inter-American Development Bank and the African Development Bank, as well as Japan's longtime concern, the Asian Development Bank, whose president is Japanese. In fiscal 1986, Japanese aid expenditures for subscriptions to multilateral development banks increased 123 percent, although from a small base. Future prospects are symbolized in the Inter-American Development Bank's recent decision to hold its 1990 annual meeting in Tokyo.

Japan's capital subscriptions to IDA, the soft-loan window of the World Bank, have also been relatively large and rising. In 1985, for example, these subscriptions totalled \$562 million, or over 28 percent of the global total. In view of Japan's huge capital surpluses and domestic constraints on military contributions to international security, global pressure will be strong for steady expansion in Japanese contributions to multilateral financial institutions.

Japan's other area of major future concern in the international financial area must inevitably be exchange rates. With total foreign trade still only 17.2 percent of GNP in 1986, compared to 14.4 percent for the U.S., but 45.9 percent for Britain and 54.2 percent for West Germany, trade-related concern for exchange-rate stability *per se* is relatively low in Japan, compared to the major European nations. But Japan, unlike the major Western European nations, is not insulated from global exchange-rate fluctuations by a regional stabilization agreement like the EMS. Japan has a strong and rising stake in stable values for at least the yen-dollar exchange rate, particularly in view of Japan's large portfolio investment denominated in dollars. Japan's 24 major insurance companies suffered book value and revenue losses of ¥2.2 trillion (over \$18.2 billion) in fiscal 1986 on the ¥10 billion in foreign-exchange

holdings; losses by all Japanese financial institutions were considerably higher. The larger Japan's external assets become, the larger the prospective exchange losses for Japanese institutions will be—unless some means is found to arrest or hedge the steady decline of the dollar.

Japan's dollar-related foreign-exchange stabilization problems can be addressed initially through bilateral exchange rate and macroeconomic accommodations with the United States, such as the Baker-Miyazawa agreement of October, 1986, but a "G-2" arrangement with the United States, or a "yen-dollar snake" analogous to the EMS, will be sufficient for Japan only insofar as Japanese trade and investment are concentrated within the Pacific Basin. Given the magnitude of Japanese assets, and the possible long-run political difficulties of concentrating huge investments exclusively in North America, both Japanese investments and Japanese financial policy concerns will need to be more global. Japanese activism in the initiation of multilateral stabilization agreements, and continual pressure for maintenance of de facto exchange-rate reference zones seems likely.

More aggressive Japanese currency interventions to stabilize exchange rates are also probable; after absorbing around \$40 billion from the exchange markets in the last half of 1987 alone, the Japanese Ministry of Finance secured a 47 percent increase in fiscal 1988 authorization for its foreign-exchange intervention fund. Although prospectively costly for Japan, massive foreign-exchange purchases provide resources for large-scale, targeted overseas portfolio investments by Japanese financial authorities. These in turn open new avenues for stabilizing the global financial system. Japanese insistence on yen-denominated U.S. Treasury issues, like the Carter bonds of the late 1970s, could also be a future possibility, as noted above. But it would take an extended period of turbulence in the global economy, with discernible, threatening contours to elicit strong movement away from the continuing tradition of the reactive Japanese state, and toward a pattern of decisive unilateral Japanese activism in international economic affairs.

Implications for U.S. Interests

The preceding pages have stressed four fundamental characteristics of Japanese foreign policy as it approaches the 1990s: (1) the reactive character of Japanese diplomacy—i.e., a propensity to avoid proactive policy commitments, but to be pragmatically flexible under pressure; (2) a disposition to contribute to the broader global community, where international pressure so dictates, through financial support for existing multilateral institutions, rather than through more aggressive independent initiatives, either in the military or economic areas; (3) growing conservatism with respect to international financial issues such as exchange rate stability and safeguards for international investment, flowing from Japan's creditor status. Japan has a deepening interest in stability of the international financial system, and will likely be increasingly active in sustaining that stability. (4) Ambivalence on international trade issues involving growing openness in agricultural products and commodity manufactures, as demonstrated by the June 1988 U.S.-Japan beef/orange agreement combined with continuing reluctance to liberalize labor-intensive manufactures and the distribution sector. In the short run, foreseeable Japanese economic and security policies seem broadly congruent with traditional American interests, and could play a fundamental role in helping sustain monetary, if not trade stability, in a period of global transition. But in the longer run, stronger divergence of U.S. and Japanese interests seems possible, particularly should Sino-Soviet economic growth be vigorous, should trans-Pacific trade tensions intensify, and should energy and other raw-material shortages recur.

In the short run the reactive character of Japanese policymaking, and the broad benefits flowing to Japan from the U.S.-Japan economic relationship make it likely that Japan will give clear precedence in its international dealings to U.S. concerns when those are clearly expressed, while continuing to deal pragmatically with all nations where no clear, specific, and strongly expressed U.S. preferences are involved. This basic reality is clear in the Japan-Soviet-Chinese triangular relationship. In 1986 around 39 percent of total Japanese global exports came to the United States, compared to less than 5 percent going to China and under 2 percent to the Soviet Union. The relative profitability of Japanese exports to the U.S., as compared to possibilities elsewhere, has been even greater than the relative trade volumes suggest. In addition, Japan has huge and growing investments in the United States—both direct and portfolio—which have no analogue in Japan's relations with other major powers.

There are, to be sure, some Japanese industries which find themselves quite heavily reliant on Soviet, Chinese, and East European markets. Twenty-one percent of Japanese steel exports in 1986, for example, went to China, and a further 9 per-

cent to the Soviet Union; only 16 percent came to the U.S.-Japanese banks, as of September 1987, also had \$14 billion in loans outstanding to Eastern Europe and the Soviet Union—40 percent of all loans by the Western industrialized world to these nations. But future expansion of Japanese trade and financial relations with the East is deeply dependent upon uncertain East Bloc foreign-exchange circumstances and growth prospects.

Soviet and Chinese foreign-exchange circumstances depend heavily on the global prices of energy and other raw materials—the major exports of these nations. Labor-intensive or commodity manufactures hold less potential, particularly in relation to the Japanese market, due to politically sensitive competition with domestic production. Should global raw materials prices rise, and shortages appear, large-scale East-West trade would appear considerably more attractive for Japan, given its shortages of raw materials. This would be particularly true should severe trade tensions develop with the United States and other Western nations. But barring this combination of unusually attractive circumstances for Japanese East Bloc trade, and extraordinary strains in trans-Pacific relations, fundamental redefinition of Japan's foreign relations away from the U.S.-Japan alliance seems highly unlikely.

Relatively few prospective developments in Japanese relations with Eastern Europe would seem of particular concern to the United States. One would be a continuation of the systematic diversion of militarily relevant technology to the Soviet Union presented by the recent Toshiba case. New Japanese safeguards have been implemented to prevent such diversion, but the U.S. must continue to vigilantly monitor any prospects for diversion. The second area of concern would be the nature and magnitude of Japanese support for Eastern European export industry. Institutional and cultural obstacles obviously make it difficult for Eastern European states to achieve large-scale export-driven industrialization on the pattern of the East Asian NICs. But the role of Japanese capital-equipment exports, capital, and local marketing networks in the success of the NICs should not be forgotten. The U.S. should seriously consider what role it would like to see Japan, as well as other allies, play in any export-oriented industrialization in the Soviet Union and other East Bloc nations, and how it can promote coordinated policies among the allies.

Some ask what the long-run impact of heavy Japanese investment in the United States will be on trans-Pacific ties, and on fundamental American national interests. Despite considerable publicity, Japanese investment in the U.S. remains quite small—considerably smaller than British and Dutch investment. In 1987 Japanese investment in the United States increased by less than half the \$19.1 billion that British investment increased, and involved less acquisition of existing business and more job-creating establishment of new facilities.

Although generally a positive contribution to the American economy, Japanese investment in the United States—and foreign investment more generally—presents two sets of questions which merit public policy consideration. The first relates to national security—the complex of issues presented by the Fujitsu-Fairchild acquisition case. The second set of questions relates to American access in foreign markets. In the case of U.S.-Japan trade relations, access to the Japanese market is largely dominated at present by Japanese firms, particularly general trading companies. Under conditions of a strong yen, and a weak dollar, which are likely to persist for some time in view of the continuing multilateral and bilateral payments imbalances, Japan will be under strong economic as well as political pressures to expand imports. Whether Japan's import expansion will occur through the expanded export operations of existing American firms, or through expanded Japanese investment in U.S. facilities designed specifically to produce for export back to Japan is still unclear, but is a long-run question worth further consideration in the United States.

An equitable U.S.-Japan trading relationship is a fundamental U.S. national interest, and the efforts of our trade negotiators in all sectors of their market-access negotiations should be encouraged. But we should not forget that Japanese domestic political structure creates rather pronounced cross-sectoral variation in the relative cost and benefits to the U.S. of various market-access demands which we pursue. Broadly speaking, the overall benefits to American firms will be greatest by emphasizing market access in sectors where the following characteristics prevail: (1) high Japanese dependence on the U.S. market; (2) high value-added and rapid market growth internationally; and (3) low employment-intensivity in Japan. In such sectors the prospective American gains and prospective American leverage with Japan will generally be highest. High-technology sectors such as telecommunications and microelectronics, finance, and processed agricultural goods, for example, merit particular attention in terms of these criteria.

The unusually pronounced dual-structure of the Japanese economy—particularly the unusual salience of labor-intensive manufacturing and inefficient distribution—could well make it difficult for Japan to become a large-scale importer of Third World manufactures, as the United States has traditionally been. China and South-east Asian nations may find themselves in deepening conflict with Japan over this issue. But the U.S. should reflect clearly on its own national interests before pressing broader demands. While maintaining general fidelity to the principle of multilateralism in international trade, we must inevitably give clear negotiating priority to bilateral questions, such as those in the high-technology and financial area, which are of direct economic significance to the United States and relatively easy for Japan to accommodate politically.

It was the United States alone, in the 1950s and 1960s, which took the basic initiatives that transformed the Atlantic Community into a Trilateral world, and brought Japan into a responsible position in the broader community of advanced industrialized nations. It was the United States which pressed for Japanese admission to and encouraged responsible Japanese roles in the GATT, the IMF, and the OECD, at a time when our European allies preferred narrower regional arrangements. The long-run result has been to leverage American power in the world community and to sustain it beyond the day when economic circumstances would otherwise have dictated more rapid decline.

We have clearly paid costs, in the erosion of our national industrial base, for the way we have managed the financial resources lent to us by Japan over the past six years of large-scale capital inflows. But those costs flowed from the sorts of internal trade-offs between defense and industrial development which we made as a nation, and from our own failure to shape a malleable U.S.-Japan relationship more in our own interests. We must press Japan steadily to bear a larger share of global burdens; equity demands this, and the reactive Japanese policy process will not easily move without well-focused outside pressure. But the fundamental decision in favor of trans-Pacific interdependence, and in favor of involving Japan deeply in the affairs of the industrial world, has not been mistaken. Japan's political and economic structure is so configured as to be broadly responsive, at least over the coming decade, to most American goals for the international system. But we must be far-sighted, astute, and calculating—in our own interests—in the design which we shape on behalf of both nations, for the world as a whole.

Mr. NANTO. We'll next turn to Ron Morse.

STATEMENT OF RONALD A. MORSE, DEVELOPMENT OFFICER, LIBRARY OF CONGRESS

Mr. MORSE. What I'd like to do is read a part of my paper and then elaborate on some of the points that are made in there.

It seems to me that even though this particular conference is focused on East Asia, the issues that we've been dealing with really deal with some more fundamental questions that have been raised at a much more general level by people like Paul Kennedy, who writes about the rise and fall of nations. He discusses the trade-off between military and economic strength. Or, as a number of conservatives, critics of Kennedy, have argued, that in fact ideas, ideology, politics are what determines whether countries reallocate their resources or not. Those of you who are familiar with the American political system know that we make economic policy based on politics. When we change a regime, we change our economics. And in some ways, I would argue that is what the Japanese do. They are very clearly politically motivated, and that just to extrapolate out in straight economic terms on a number of these issues might be somewhat misleading. I think a couple of speakers this morning touched on this in their own way, especially regarding what's taking place among the newly industrialized countries in Asia.

The other point I would make, and I raise this point in an article I had written last year, which is that countries really only have in-

terests, and the best thing that we could possibly do for Japan, I think, and for ourselves would be to define more clearly what we mean in our relationship with Japan, because I think—this is one of the points I'll develop here—I think that until Japan and the United States clearly sort out what their mutual interests or differences are, that Japan in fact will not be able to have a clear cut relationship with the rest of the world. If you think of Japan's relationships with the rest of Asia, you think of Japan's relationships with the Soviet Union, it's always in the shadow of the America-Japanese relationship. And so clarifying the U.S.-Japan relationship rather than, as everybody tries to do, make it more difficult to understand does a service not only to ourselves, but to Japan.

What I'd like to do is just elaborate a little on why I think the Japanese are not ready for this based on the domestic political scene. And the second thing is look at the Japanese side only—I'm not going to talk about the America side. We know a lot more about that and we know where the problems are a little bit more clearly. But on the Japanese side, the Japanese clearly come out of a social, political, and cultural context, within which they perceive the world. And one of the things that nobody yet has come up with an answer to, but I want to explore it a little bit, is that we all know that the British had a perception of what the world order would be under the British Empire. And the United States has ruled the world in a particularly American way. The Soviet Union clearly perceives the projection of its power, economic wealth, whatever, in a particular way. And yet we have no idea how the Japanese—when they are strong, and they will be strong—by any measure of what they're doing, there is no doubt they will be as strong as the United States, if not stronger. The question is do we have any idea where they're going.

The way I put it in my written text was that there is very little happening on Japanese domestic political scene to indicate Japan's leadership has an ideological underpinning or a plan for active global participation. And secondly, that the cooperative schemes Japanese and Americans are now discussing—that's all these things that appear in the pop literature that we're all exposed to—based on a misreading of Japanese trends and unimaginative about how the United States insures that his global principles and interests are preserved in advance. The Japanese, and I didn't realize how pertinent the superman cover on my paper would be at the time I put this on there—there are two basic strains anybody who knows Japanese history are aware of. You go back to the Meiji restoration (1868) and the way that Japan came out of that, the growth of the greater co-prosperities here in Asia. In every nation, and Japan is not unique in this, in every nation there's a growth for autonomy, a growth for national identity, a growth to be independent, a growth to be strong.

It seems to me that there are two basic trends in the Japanese political world today and the Japanese themselves haven't been able to come up with leaders that go one way or the other. The Japanese have been seeking for some kind of political superman. They had "Ultraman" for those of you who used to collect Japanese dolls in the old days, and if you went to the department stores, there was this large silver creature that used to be around.

They have all kinds of "Transformers" and all the great robots and all the things that we've all been exposed to. They are the result of a society that comes out of a strong militaristic, feudalistic tradition, and they have a sense for what it's like to deal with these kinds of things. So the Japanese have always had a superman-interest and in fact, today in the postwar period as opposed to the prewar period, they've in a sense identified with the characteristics of "superman." When you think of a superman, we all think he stands for something that's good. He puts criminals in jail. He uses his strength for good purposes. He comes from outer space. He has super powers. He has technology—kryptonite. He has all the qualities that a sort of independent powerful Japan that could balance America and the Soviet Union against each other and make the world into a peaceful place. This really has a tremendous amount of appeal to Japan. The trouble is that to be Superman, one has to have kryptonite, or one has to have something equivalent.

If you link Japan's recent two past political leaders, people that all of you in some form or other have been exposed to or at least seen on television, Nakasone, the former prime minister, and the present one Takeshita, I think they represent the two counterforces within the Japanese political scene—Nakasone being the one which would be the Superman-type without the good will perhaps, and Takeshita would be the one who would hiding from Superman as he does careful work. Nakasone was admired by Americans because he was so atypical to the Japanese stereotype. He was a risk-taker with some interest in foreign affairs, a Confucian scholar-type administrator who liked ideas, but he disliked day-to-day domestic factional politics. He seemed to know where he and Japan were going, even if no one was going to follow him. He liked knowledge, but didn't appreciate power. He could make promises, but he didn't have the capacity to deliver on them. He was a good front man in many ways for Japan during a period of 5 years of strong bilateral tensions with the U.S. Takeshita is a far more complex and interesting figure, at least in Japanese terms. If Nakasone was the technician on the model of a chess player, then Takeshita is the poker player. Takeshita knows when to play them, and when to fold them. Takeshita who said his political slogan as prime minister would be bold ideas and delicate execution, is the slow methodical type, a steady type. I suggest you read his so-called *My Home Town Theory of Ruling Japan (Furusato)*, which was published just prior to his becoming prime minister. He's a master of political tactics, which in Japan means control of people, money, and power. He's a coalition builder, a master of parliamentary management. He thrives on power brokering and domestic politics. His conceptual framework is what works, and this is important, I think. Takeshita's foreign policy agenda is in the hands of the foreign ministry because he believes that what happens at home is what really counts for Japan in the long run. His new 5-year economic plan, however, has no bold ideas and his foreign policy objective is cooperation for peace, cultural exchange, and more foreign aid. Anything but fresh. The Policy Affairs Research Council related to the LDP that Kent Calder mentioned or the Liberal Democratic Party is his power base. He's a machine politician. If Nakasone looked outside of Japan for courage, Takeshita looks inward to the

strength of the nation for economic reform, greater competitiveness, and tighter political control over Japan's future by fostering science, technology, and education.

And he can deliver on what he sets out to do. He can help make Japan "number one" while ignoring the global implications. Nakasone embarrassed himself with his proposals to the business community. We all remember how he called on all the Japanese people to spend \$100 to boost the imports of the United States. Takeshita's style frees up the business world to build its economic empire. Put brain power and advanced technology products in Japan. Put all the other products that need to be produced in lower-waged nations throughout Asia. Put the assembly facilities where the markets are, like in the United States, and then put corporate headquarters wherever the tax advantages are the best. Information and economic knowledge is the business community's need: high technology, its means, and profit, its goals. And Takeshita will allow that and he will be in power for the next 3 or 4 years. He will allow the business community to pursue its interests and perhaps in a very ruthless fashion.

In Japanese politics today, there are two issues that evolve from this leadership bifurcation. One is that the high profile style of Nakasone runs the risk of confusing Japan's technological and economic achievements with a sense of cultural superiority. This has surfaced in a number of occasions. This whole question of do the Japanese confuse cultural identity, a sort of Japan-theory, science theory, and all the rest of it with some of their technological achievements. Neo-nationalism as some define it was a concern during Nakasone's administration. This confusion of issues could easily slip over into a moral justification for Japan to acquire more significant power. This is one very important dimension of the Japanese political equation—the drive to be number one, and it can't be ignored. It was on Nakasone's watch that Japan's number one theme reached its greatest popularity.

Second, Takeshita's style poses a very different problem. Foreigners find this style hardest to understand but easiest to deal with. And again this is something we have to be careful of. Hard to understand because they fail to grasp the political and psychological operating principles; easiest to deal with because it appears accommodating and nonthreatening. He seems happy to let the world go its merry way. Takeshita, as he has demonstrated, will make painful domestic choices. We've seen a number of them. He's only been in power since last November. We've seen a lot of issues that have been on the agenda for a decade, resolved. He will make powerful choices at home on domestic issues because he has the power to move and the power to deliver the benefits and make the tradeoffs that are necessary. He will resolve a number of special interest issues with the United States. This gets him support at home and abroad. The Japanese business world will be happy to pursue its interests without interference. The Foreign Ministry will fill the foreign policy void with cooperative schemes that will help delay the questions about long-term foreign policy objective and we've already seen this. Takeshita is likely to be in office, as I said, 3 or 4 years. The political leaders in this country are going to have a difficult time in dealing with Japan unless they give careful thought to

this. A strong Japanese economy, a Japan increasingly influential with the Asian NIC's, as we heard earlier today, firm domestic political leadership, and an accommodating but nonassertive foreign policy could place Japan in a very favorable light worldwide in the next few years.

Now because of this political dynamic, and because of the forces operating within Japan, it seems to me that the whole question—and I won't go into all the details contained in the paper I have included here—but in the last couple of years there have been a whole series of articles on attempts to deal with America. Z. Brzezinski's article about how we have to have an Amerippon—some type of consortium, some type of U.S.-Japan scheme in which we have a sharing—let Japan run the economic world and we'll protect everybody. We'll be the mercenaries for the rest of the world. There are other Japanese schemes. There is the "Pax Americana I" and "Pax Americana II," which is very popular in Japan these days. In other words, up until the 1980s, the United States was the great global leader, but since 1980, with the whole reversal of all of the economic trends we heard earlier, with the decline of America's competitiveness, with the weakening of its military structure, with all the things the Japanese love to talk about and a lot of Americans do, too, there is a sense that the United States is really on the downward slope, while Japan is on the rise.

Now behind these schemes, most of them coming out of Japanese literature—is a Japanese assumption about their taking over leadership in the world. There's been a tremendous amount of writing about the anatomy of dependence and how Japan sees the world and tries to build linkages. (My paper discusses this in detail.) All the vocabulary of the Japanese articulation of foreign policy is in terms of being vulnerable from all sides, reaching out and forming bridges, building mutual interdependence, building dependence. The word "independence" is something Japanese have difficulty dealing with. People of the United States are always saying to Japan, stand up! You've earned it! You're strong! Do something! And the Japanese always run for cover, because they want to build somehow under this existing system that they've grown up under in the last 40 years that's been very beneficial to them. They want to continue this sort of benign dependency relationship where the United States guarantees the strategic umbrella. The United States essentially forges the frontiers; as the United States goes into Iran, Japan goes into Iran. If we go into the Soviet Union, the Japanese will go into the Soviet Union. There's always a beachhead taken before the Japanese assault troops come in behind the French, the Germans, and a few others. That type of world the Japanese have grown up under feeds on their own personal dependency psychology, their own social psychology, their own social organization, in a way that they find it very hard to abandon. If you look at most of the literature today about what the United States should do, it's Japanese material, because they're more concerned about what happens if we weaken than we are. We as a nation in fact are not too concerned with a number of the issues which people here alluded to today. The Japanese are very concerned because they're reading the tea leaves of what happened in the past. They're reading the economics, the data they themselves have used to craft their

own rise to power, and they also know that to get into the 21st century safely, they've got to have some cover, and they don't want us to start to begin to, for example, require significant burden sharing. The Toshiba COCOM leak was a shocker. It was a shocker because it shakes the very fabric of this dependence, not so much because of the particular issue. It raises questions that they don't want to face in their relationship with the U.S.

Now within this sort of overall context, it seems to me that the United States really has to begin to ask what is really in it for us in the long term and do we want to live essentially under a Japanese empire. It sounds foolish. It sounds cynical to say, but it's very possible that by the time we get into the 21st century, that before say the Secretary of State makes a major foreign policy decision, he will have to make a phone call to Tokyo, to make sure it doesn't impinge on anybody else's foreign policy, i.e., Japan. We're already seeing that economic sanctions by the United States, all the way from the late 1970s with Iran right to the present, are no longer working. Economic sanctions as a foreign policy tool are not working. When people like Professor Paul Kennedy say that we have to craft a new diplomacy for the future based on our weakening economic and by implication, political and strategic strengths, I don't think he's talking in a foolish way. The debates about what we should do in the way of protectionism and economic restructuring—if you go back and read the debates in England in the late 1890s and the turn of the century, they're identical to ours today just plug in "America" for "England" and basically the debates sound the same. So I would say that we should broaden the discussion of Japan away from the United States-Japan package. I think the Asian NIC's and what's happening in Asia and in this conference in particular, is broadening it out to the whole of Asia. But I think it's much more fundamental to put it into a broader context. And this is where we get into what I'm sure you all would like to talk about—the fact that the United States has no strategic plan about what its global interests are. And so the whole question of should we be lulled into, as certain critics of the United States, certain people in Japan, certainly the Japanese Foreign Ministry and a number of other groups, would like, accommodating ourselves to the fact that Japan is very important and that the way that they are defining the nature of the relationship and the context within which they're defining it is the context within in fact, we want to define it. Will they defend our interests globally? Will they pursue the interests of the world the same way that we have? Will they guarantee our strategic protection?

So I think that we shouldn't be fooled into thinking that economics is the only question for our relations with Japan. I think there's a whole fundamental area of the nature of the two societies, and more importantly, defining national interests more clearly and not being lulled into an ideological, sort of mental framework within which we preclude the question of treating Japan as a country with its own interests and a country as having interests that could diverge significantly from the United States in the years ahead. And I think some of the things that were said this morning, especially the economic realm, would raise that question as well.

Mr. NANTO. Thank you Ron. Your prepared statement will be inserted in the record.

[The prepared statement follows:]

PREPARED STATEMENT OF RONALD A. MORSE, DEVELOPMENT OFFICER, LIBRARY OF CONGRESS

SUSHI AND APPLE PIE: THE GREAT POWER GIVE-AWAY

Six months ago, in an article in *Foreign Policy* (Winter 1987-1988), I wrote as follows:

"Japan is arguably the most significant country in the world for the United States. If any country surpasses the United States as the world's leading economic power, it will be Japan, not the Soviet Union. How Japan would use a position of such strength would, in turn, determine whether the United States faced the 21st century with confidence or apprehension. For if the United States can reconcile its national interests with a preeminent Japan, it can rest fairly confident that international political and economic structures will remain protective of U.S. security and welfare. But if the United States miscalculates Japan's intentions and strategy, Americans may find the international order would over time be structured in a way harmful to U.S. interests.

"Thus there are few tasks more important to U.S. policy-makers than understanding Japanese objectives over the long run. What are Japanese concerns? What do they think about their relationship with the United States?"

Since then, I am not convinced that much progress has been made toward a better mutual understanding of how American and Japanese long-term national interests will converge or diverge. There are complex reasons for this, but I want to explore slightly more carefully than I have earlier two aspects of the issue, mainly on the Japanese side, that deserve more careful consideration.

What I would like to do is to begin by discussing some recent political development within Japan and then relate these developments to Japan's effort at post-World War II self-definition, primarily in relation to the United States. The two basic points I wish to make are first, that there is very little happening on the Japanese domestic political scene to indicate that Japan's leadership elite has an ideological underpinning or plan for active global participation; secondly, that the schemes Japanese and Americans are now discussing for greater bilateral cooperation are based on a misreading of Japanese trends and unimaginative about how the United States ensures that its global principles and interests are preserved and advanced. While my comments are about Japan, I should say that equally serious debts and questions can be raised regarding U.S. leadership and policy today.

The Search for Superman

The Japanese have had a number of indigenous variations of "Superman." The most famous was "Ultraman"—there have been others—but none of the home-grown variety has the qualities of the real Superman—strength, humanity, the using of power for good purposes and, because of his origins, a unique technical or scientific superiority. The qualities of a sage or statesman that Superman possesses are unfortunately very rare—as they are in the political realm—on planet Earth.

While Japanese history shows that Japanese leaders have all aspired to some form of power and influence and have usually had strong convictions about the justness of their purposes, in the postwar world there have been no real "supermen" coming out of the Japanese political system. Indeed, there seems to be a clear differentiation between those leaders who have power and those who exercise foreign affairs leadership. What Japan has had in the way of prime ministers and top political leaders is best exemplified in the characters of the immediate past prime minister, Yasuhiro Nakasone, and the current prime minister, Norboru Takeshita. They represent two very different political leadership styles, neither of which alone can get Japan or the free world into the future safely.

Nakasone was admired by Americans because he was so atypical of the Japanese stereotype. He was a risk taker with some interest in foreign affairs, a Confucian/scholar-type administrator who liked ideas. But he disliked day-to-day factional politics. He seemed to know where he and Japan were going, even if no one was going to follow him. He liked knowledge but did not appreciate power. He could make promises, but did not have the capacity to deliver on them.

Takeshita is a far more complex and interesting figure, though he too is only "half a superman." If Nakasone was the technician on the model of a chess player,

then Takeshita is a poker player. He knows when to play-em and when to fold-em. Takeshita, who said his political slogan as prime minister would be "bold ideas and delicate execution," is the slow, methodical and steady type. He is a master of political tactics, which in Japan means the control of people, money and power. He is a coalition builder, and a master of parliamentary management. He thrives on power brokering and domestic politics. His conceptual framework is "what works."

Takeshita's foreign policy agenda is thus in the hands of the Foreign Ministry because he believes that what happens at home is what really counts for Japan in the long run. His new five-year economic plan (Japan Living the World, 1989-1993), has no bold ideas and his foreign policy objectives of cooperation for peace, cultural exchange and more foreign aid are anything but fresh. The "Policy Affairs Research Council" of the ruling Liberal Democratic Party is his power base vis-a-vis the bureaucrats and business community. He is an (LDP) machine politician.

If Nakasone looked outside of Japan for courage, Takeshita looks inward to strengthen the nation through economic reform, greater competitiveness and tighter political control over Japan's future by fostering science, technology and education in a very broad-minded and egalitarian way. And he can deliver on what he sets out to do. He can help make Japan Number 1 while ignoring the global implications.

Nakasone embarrassed himself with his proposals to the business community. Takeshita's style frees up the business world to build its economic empire—put brain power and advanced technology products in Japan, other products are produced in lower-wage nations throughout Asia, put assembly facilities where the markets are (like the USA), and have corporate headquarters located wherever the taxes are lowest. Information and economic knowledge is the business community's need, high technology its means, and profit its goal. This will roll on without much interference.

In Japanese politics today, there are two issues that evolve from this bifurcation of political leadership styles. The high-profile Nakasone style runs the risk of confusing Japan's technological and economic achievements with a sense of cultural superiority. Neo-nationalism, (as some defined it) was a concern during his administration. This confusion of issues could easily slip over into a moral justification for Japan to acquire significant power. This is one very important dimension of the Japanese political equation—the drive to be Number 1—and it cannot be ignored. It was on Nakasone's watch that the "Japan as Number 1" theme reached its greatest popularity.

Takeshita's style poses a very different problem: Foreigners find his style hardest to understand but easiest to deal with. Hard to understand because they fail to grasp the political and psychological operating principles; easiest to deal with because it appears accommodating and non-threatening. He seems happy to let the world go its merry way.

Takeshita, as he has demonstrated, will make painful choices at home on domestic issues because he has the power to move and the power to deliver benefits. He will resolve a number of special interest issues with the United States. This gets him support abroad. The Japanese business world is happy to pursue its interests without interference. The Foreign Ministry will fill the foreign policy void with cooperative aid schemes that will help delay questions about Japan's long-term foreign policy objectives. We are already seeing the evidence of these moves.

Since Takeshita is likely to be in office for another three to four years, American political leaders are going to have a difficult time in dealing with Japan unless they give careful thought to their objectives. A strong Japanese economy, a Japan increasingly influential with the Asian NICs, firm domestic political leadership and an accommodating but non-assertive foreign policy could place Japan in a very favorable light worldwide in the years to come.

Sushi "a la mode"

Because of this complex, political dynamic within Japan, there is considerable confusion among outsiders about how to conceptualize Japan and its newly acquired status. As I have suggested, a good part of the confusion derives from the lack of clarity in Japanese minds about where Japan is headed. Should Japan be called a superpower? No, some would say, because it lacks the "military" might to be a power. It is a superstate? No, others mention, because it is unwilling to exercise its political clout in a way a self-confident nation would. Besides, its politicians don't command leadership respect. Is it a techno-state? Yes and no. It is good at applied science and technology, but by most measures it does not have a basic science and R&D base that even approximates what the U.S. has. Is Japan (going to be) Number 1? Some say yes, some say no. Can it be Number 1 simply with economic clout? Not likely in today's world.

The critical question, however, remains does Japan want to be Number 1? Again, the answer is yes but no. To deal with this question from a slightly different angle, one has to step back from the economic calculations, projections of defense budget expenditures, and debates over trade fairness and try to understand Japanese motivations and psychology. Again, there are two sides to the issue. Behind the current Japanese drive to excel economically and in science and technology is a strong need to be respected—the wish to be taken seriously and given credit for the successes it has achieved. This might be called the “Nakasone syndrome.” But the other side of this is the fear and anxiety of having to be a lone leader in world affairs, often out in front on critical issues.

The picture on the cover of this essay vividly reflects the strong Japanese desire to really pull ahead of the pack, leading the United States and being the driving force for other Asian states (the NICS).¹ To anyone familiar with Japan before 1930, these images have a familiar ring. To those familiar with the current vast literature in Japan on the “rise and fall” of nations and the Japanese projections of what the world will look like in the 21st century, this sketch of “Super-Japan” comes as no surprise. Japan’s self-confidence is way up and the pride of success is evident in the attitudes of Japan’s business elite and reflected in the pride of Japanese public officials anxious to be labeled as a “tough negotiator” on foreign affairs.²

But if the Japanese have this economic clout and political/military potential why don’t they step forward and more aggressively exercise leadership? Why on every occasion do they try to thrust power away? Is it just the nature of Japanese political leadership, as I suggested earlier? Is it a fear of repeating the mistakes of the 1930s? In answer to this, I would pick up on arguments made some years ago and contend that the foreign policy vision of Japan’s current ruling elite is built upon two pillars: (1) a cultural psychology of dependency; and (2) a U.S.-dominated strategic framework within which Japan has had a junior partner, dependent status for the entire postwar era.³ The social, psychological and institutional structures of Japanese dependence and vertically structured relationships are well known to those who study Japan. The manner in which these cultural traits are transferred to the U.S.-Japan relationship and Japanese foreign policy more generally was already discussed in reference to Prime Minister Takeshita. As I tried to suggest, without a framework linking culture to foreign affairs it is impossible to appreciate Japanese foreign trade patterns, explain Japan-Soviet relations or even explain how the policy of foreign pressure on Japan (*gaiatsu*) works. I am reluctant to assert this, but feel it is accurate to say that the entire U.S.-Japan relationship is based upon a set of Japanese psychological assumptions that are largely unconscious to Japanese and misunderstood by Americans—adding a complex layer of tensions to an otherwise straightforward two-power relationship.

The best and most evident manifestation of this dependency mode is the way the Japanese have been trying to seek a historical justification for their views. They have been trying to seek a historical justification for their views. They have done this by sorting out the phases of American power growth—how it rose, when it will decline and how the process, for example, compares with Pax Britannica and earlier historical cases. Their superiority is based, perhaps, on the law of economics and history.

One recent popular scheme postulates that *Pax Americana I* covers the era up until the early 1980s—America’s rise to a world leadership role, economically, politically and strategically. *Pax Americana II* focuses on the current “relative” decline of American hegemony and the transformation of the U.S. into a debtor nation suffering from what Yale professor Paul Kennedy terms “imperial overstretch” in his book *The Rise and Fall of the Great Powers*. America’s military and other commitments globally have, according to Kennedy, taxed the domestic economy to the point of danger. If Americans do not mend their own fences, then too bad!

The Japanese literature on this suggests, however, that the Japanese are psychologically unprepared to accept the serious decline of America and out of obligation make every effort to advise us on how to improve our competitiveness and treat our productivity as a top national priority. It is no exaggeration to say, from what I have read, that the potential “rapid” decline of America is the largest major threat to Japanese national security. (One might add as an aside, that given what Chinese and Southeast Asian leaders say about the need for American to continue to domi-

¹ This was taken from the cover of a June 1988 *Shukan Toyo Keizai* magazine.

² Morse, Ronald, “Japan’s Drive to Pre-Eminence,” *Foreign Policy* (Number 69), Winter 1987–1988.

³ See Doi, Takeo, *The Anatomy of Dependence* (1973) and Nakane, Chie, Japanese Society (1970).

nate Japanese political and military policy, that they too are hooked on the American global hegemonic scheme, at least in the Pacific.)

The Japanese are fascinated with the eventuality of *Pax Nipponica*, especially as long as American scholars promote the idea, but have little real enthusiasm for the concept in its full expression—as a country stronger than America. The memory of World War II and the abuse of power still lingers. They still wish to be supermen, but with the United States setting the guidelines for the use of Kryptonite! They prefer a range of alternative “dependency” arrangements that allow them freedom of action within a secure strategic environment. Most Japanese analysts prefer the joint or bilateral *Pax Ameripponica* scheme—a grand historical venture—a leadership coalition or condominium style of U.S. and Japanese rule with Japan’s role being primarily economic and America retaining a strategic and political leadership role.

Some “multilateral” scheme that places Japan in a more central role with the U.S. could include: *Pax Consortium*—a more loosely defined alliance structure including the European community and some of the Asian newly industrializing nations (NICS). A regional subcategory of this concept could be terrible phrase “Japanics,” referring to Japan’s leadership role with the Asian NICS.

Another theory on how Japan might “manage” its relations has been termed “coordinatorship”—an effort “to achieve an alignment of diverse interests and to form consensus, or an appearance of it at least, among countries.”⁴ This too is premised on a dependency relationship. How to buffer emotional reactions, reflect all views, avoid conflict and avoid taking a leadership role is central to this and all views, avoid conflict and avoid taking a leadership role is central to this and all the other schemes that permit Japan to operate securely without having to make tough political choices.

Americans who share this view on the benefits of “interdependent” economies are comfortable with these “consensual leadership” schemes because they believe that Tokyo will operate within the American orbit of influence and that a Japanese reliance on U.S. markets gives American policymakers leverage in other areas of the relationship. An example of this conventional wisdom is demonstrated in Zbigniew Brzezinski’s comment: “A greatly revitalized America can be nurtured by policies that exploit the special complementarity of America and Japanese interests, while providing Japan with the safest route to continue growth.”⁵ Such a framework allows Japan to: maintain a low-posture strategy, justify modest defense expenditures, assure access to the U.S. market, and encourage favorable treatment worldwide as an ally and “super-friend” of the United States.

But this is not the entire story. There are cautious, somewhat skeptical views that Japan’s interim interest in “shared power roles” is a temporary strategy on the way to an era of Japan as Number 1—*Pax Nipponica*. Sharing is but a step toward something else. As one prominent Japanese thinker expressed it, “Friction between Japan and the U.S. remains unabated because the foundations of Pax Americana have begun to crumble. As a late entrant to the oil civilization, Japan has a certain advantage over the U.S.: its industrial infrastructure is thoroughly up-to-date and its workers are much more willing to accept new technologies...given America’s decline and Japan’s continued growth, it is realistic to assume that Japan will acquire a greater voice in the world community.”⁶ Or as an American observer put it, “The prospects for the next few years, therefore, are for a pattern of limited and uneven *Pax Nipponica*, led by a country of modest military strength, of limited ability to attract a foreign following and to give foreign aid, but of great economic leverage.”⁷

Kazuo Nukazawa of Keidanren (Japan Federation of Economic Organizations) says “Uncle Sam reacts to Japan’s ballooning trade surplus by huffing, puffing and imposing punitive sanctions. We respond with half-measures designed to appease and buy time . . . Only a brave new model of mutual accommodation can avoid a destructive trade war.”⁸ Nukazawa, like many Japanese, suggests we need to do something, but falls short of concrete suggestions. Experience shows that the patchwork solutions advanced so far have not worked well, at least as far as the U.S. is concerned. Over the years a number of strategies have been tried to deepen and widen the bilateral consultative process—policy planning groups in economic, political and strategic areas; cross-participation business organizations; public/private

⁴ Yanagihara, Toru, “Pacific Basin Economic Relations: Japan’s New Role?” *The Developing Economies* (December 1987) p. 418.

⁵ Brzezinski, Zbigniew, “America’s New Geostrategy,” *Foreign Affairs* (Spring 1986), p. 696.

⁶ Amaya Naohiro, “America in Decline,” *Look Japan* (May 1988) pp. 4-6.

⁷ Vogel, Ezra, “Pax Nipponica?” *Foreign Affairs*, Spring 1986.

⁸ Nukazawa, Kazuo, “A U.S.-Japan Economic Balance of Terror,” *Asteion* (Winter 1988).

"wisemen" consultative groups; and a vast array of academic exchanges and meetings, to say nothing of cultural projects and discussion forums. A few people have advised the creation of special Japan or America policy secretariats to give more coordinated and focused policy attention to each other's policies.⁹ Most recently a cabinet level forum an American-Japan Council, a permanent, non-governmental institute to anticipate long-term issues and advise government leaders, have been proposed.¹⁰ These institutional arrangements are useful in providing forums for consultation, but they tend to delay asking the big question—when, where and how will Japan's leadership finally express its global strategy? And, one might add, what is the role of the U.S. in Japan's strategy?

Mr. NANTO. We'll turn now to our first discussant, Ira Wolf.

**STATEMENT OF IRA WOLF, LEGISLATIVE ASSISTANT, OFFICE OF
SENATOR JOHN D. ROCKEFELLER, IV**

Mr. WOLF. I was going to start out by apologizing for being a pessimist, but—I may be the optimist today.

I want to turn to one aspect of what Ron kept alluding to and saying that he wouldn't talk about and then kept talking about—the total inability of the United States to manage this relationship, and the fact that we're in a time warp, don't know we're in a time warp, and, therefore, have no idea of how to get out the time warp that we're in. We've all said many times that the U.S.-Japan relationship is one of the great successes of the postwar era, along with the Marshall Plan. You all know that theme. The problem is that we're still looking at that relationship, the U.S./Japan relationship, with the same eyes that we used 30 or 40 years ago. The U.S.-European relationship has evolved over the years, although I'm not sure why. As Europe grew, as Europe changed, as the world political scene changed, we continued to alter our own views of how to deal with Europe. Sometimes we did the right job; sometimes we did not, but it was an evolving process. I don't see that same process as having evolved in Japan.

Someone this morning referred to the Holbrooke thesis which is not confined to Dick Holbrooke, about how the overwhelming strategic importance of the U.S.-Japan relationship means that nothing else should impinge on it. That, of course, is the basis of policy in the 1950s and the early 1960s, and I think our decision-making process in Washington, the mechanism and the managers of the U.S.-Japan relationship are still totally fixated on that. Tom Fingar this morning referred to the growing Beijing-Seoul trading relationship and noted that economics pushes politics. I think the problem is that our policy-making apparatus and our policy-thinking apparatus is lagging seriously behind changing international circumstances, changing regional circumstances, and most certainly, changing circumstances in Japan. I think the evidence demonstrating that comes in reviewing the key issues as far as the U.S. government is concerned today—in June 1988—vis-a-vis Japan. Look at the priority trade issues of the last 6 months—beef, citrus, and construction. Why? Are these the issues that should be of priority to the United States? If you're a beef farmer or a citrus

⁹ Morse, Ronald A. and Olsen, Edward A., "Japan's Bureaucratic Edge," *Foreign Policy*, Fall 1983.

¹⁰ *Creative Engagement: Strategies for United States-Japan Global Cooperation toward the 21st Century*, issued by the Pacific Forum, June 1988.

grower or someone in the construction business who wants to sell this technology to Japan, then, of course, it is important.

How do we establish our priorities? Well, we all know how the U.S. Government establishes its the priorities in trade negotiations, but that should not be the way we do it. Mac Destler explained in his book *American Trade Politics* how we used to establish those priorities versus how we do it today. Well, I think the process used to be an awful lot better and much more effective. How do we relate trade to the rest of the relationship? We don't. We subjugate it on the one hand, and yet, on the other hand, we let it dominate. What defines the U.S.-Japan relationship? What defined it between January and June of 1988? Beef. Citrus. Construction. Beef sales to Japan defined the relationship in the minds of the American public or anyone who read a newspaper in this country.

On trade, why was Clayton Yeutter not at the economic summit? Why is the exchange rate issue not in the U.S./Canada Free Trade Agreement and barely touched upon in the trade bill? We're dealing with trade issues that have nothing to do with the broader relationship.

Let's turn to our bilateral defense relationship with Japan. There are elements in the Defense Appropriations bill that will be considered by the full Senate in a few weeks that should trouble anyone who's concerned about the Japan relationship. Burden-sharing is becoming a hot debate, at least on Capitol Hill. Some of the provisions of this Appropriations Bill are quit striking. For example, there's a ceiling put on U.S. forces in Korea and Japan, and there's a rationale for it. I don't agree with that rationale, but there's a numerical ceiling put on U.S. forces in those two countries based on a cost and burden-sharing argument. It's quite remarkable, when you think about it.

Another provision relates to the Midway, which is an aircraft carrier based in Yokosuka. Under the bill, unless Japan agrees to finance repairs of the Midway in Japan, we'll repair it in the United States instead. This may take it out of service for several additional months. We've been trying to sell a very high-tech military defense system named Aegis to Japan for a number of years. Well, Japan has agreed to buy it. We think that it is a necessary part of the structure of the U.S.-Japan defense relations. This bill says that we won't sell Japan the system unless they buy ships built in the U.S. to put it on, as compared to ships built in Japan. We're talking about Japan increasing its defense capability, its defense role. We want them to play a greater role, but maybe we don't want them to play greater role in decision-making. I think Kent Calder's reference in his paper to an willingness to give the Japanese additional voting rights in international financial institutions is another aspect of this ambivalence regarding a strong and powerful Japan.

Investment will be an important issue next year. It's an oratorical issue this year, but perhaps a legislative issue in 1988. You've all read the various debates, the Tolchin book, the press. The target is Japan, irrespective of how the statistics come out, irrespective of job creation, and so on. If the trade bill passes and is signed, investment will be the U.S.-Japan issue next year—the emotional one, the headline issue—defining our relationship.

What are we ignoring in the relationship? On the trade economics side, we're not paying attention to technology. Who cares about technology? Senator Rockefeller held a hearing on the Japanese patent system last week, hopefully, the beginning of a look at how to protect American technology in Japan. How do you assure that the guy who invents the technology is at least given the opportunity to commercialize it? If he can't commercialize it, well, that's another thing. But at least give him the chance. He doesn't even have that chance now in Japan.

I would like to see a comprehensive U.S. policy toward Japan. I don't think we're making any effort at that—at establishing a policy that looks at trade and economic affairs as national security both as a direct contributor to national defense as well as the determinant of a way of life, a standard of living. This comprehensive look has to deal with everything. The question is how do you do it? How do you get a group of people together, a group of Japan experts, to devise a new comprehensive U.S. policy towards Japan, but somehow keep those folks who have been managing the relationship over to the side, so that they can tell us about their experiences, but then get the people who are willing to address the trade, economic, technology set of issues as critical.

Mr. NANTO. Thank you, Ira. Glen.

STATEMENT OF GLEN FUKUSHIMA, DEPUTY ASSISTANT TRADE REPRESENTATIVE FOR JAPAN AND CHINA, OFFICE OF THE U.S. TRADE REPRESENTATIVE

Mr. FUKUSHIMA. I have defined my mission as much more modest than that of the two previous speakers. I was asked to comment on the papers by Kent Calder and Ron Morse that were presented, so I'll confine myself to that, and conclude with a few observations of my own. I also want to note that I'm in a somewhat different position from the other three panelist in that as a member of the Executive Office of the President I am on a daily basis engaged in trade negotiations with Japan. In the past, I have said things at conferences such as these and was surprised to find my comments printed in the newspapers the next day. So I have to be rather careful about what I say here today.

First, let me discuss Kent's paper, which I think is a very good, accurate analysis and description of where we stand now in the U.S.-Japan relationship. But the paper is short on prescription. My real criticism is that it doesn't draw out many of the implications that might emerge from his analysis. In an attempt to be a balanced objective academic observer, Kent perhaps understates the seriousness of the problems the U.S. faces with regard to Japan, especially in the economic area. Also, by focusing exclusively on the economic aspects of the relationship, he doesn't make the linkages or draw implications for other areas, such as the political, military, economic, security, scientific, and technological dimensions that obviously are intertwined with, and greatly influenced by, the health of the economic relationship between the U.S. and Japan.

He mentions in his paper an "alliance" between the United States and Japan. One of the central issues is what do we mean by this alliance or partnership between the U.S. and Japan. I think

Ron Morse is right that the U.S. and Japan look at this relationship in very different ways, with different expectations of what we the relationship. One of the dilemmas on the U.S. side is that on the one hand, we want Japan to take more of an independent role. We want Japan to take more initiatives, especially in the economic area, but perhaps even in the military and security defense areas as well. But there's also the fear that with independence comes potential autonomy and the possibility that Japan is going to be much less willing to listen to what the United States wants Japan to do. And therefore, it does come back to the question of what it is that we in the United States want in the long term, and how that relates to our relationship with Japan. I'll return to that towards the end of my comments.

One of the troubling aspects of Kent's paper is that he draws a somewhat black and white dichotomy—either Japan takes a strong leadership role and exercises initiative, or the U.S. does. I think the real likelihood is that Japan will not take such an initiative, but at the same time, the U.S. is not going to be able to do so either. Thus, there is going to be a vacuum which no single country is going to be able to assume the leadership role that the United States took, say 20 years ago. And in such a vacuum, the possibility of Japan reaping the benefits are much greater than the United States.

Kent's paper examines the notion of Japan dealing with the United States on a bilateral basis versus looking at it in the multi-lateral context. It seems to me, based on my negotiations and discussions with Japanese government officials, that there's a generational issue here: many of those in the Japanese bureaucracy who are in office director and above positions, who joined the ministries in the 1940s, 1950s, and into the 1960s, do look at the U.S.-Japan relationship as the centerpiece of Japan's international obligations and commitments. Whereas many of the younger officials who have joined within the last 10 or 15 years look at the United States as just another country, one of 150 or so countries Japan deals with. If the United States comes to Japan with a particular problem, many people in that earlier group would consider it to be something that Japan should take seriously, whereas some of the younger officials are likely to dismiss these U.S. concerns as merely representing a lazy, slothful, uncompetitive country coming to Japan for special favors. I agree with the conclusions in Kent's paper about the necessity for the United States to continue to pressure Japan to open its market, and the need, as Kent says, for the United States to be "farsighted, astute, and pragmatic" in its relation with Japan.

There are, I think, a number of commonalities between Kent's paper and Ron's paper, although Ron tends to focus more on the psychological and cultural dimensions rather than the economic and political dimensions of the U.S.-Japan relationship. In contrast to Kent's careful, measured, and academic tone, Ron, as usual, is provocative. I agree very much with Ron that we need to define more clearly what our mutual interests are—the United States and Japan—and that Japan is more likely to be influenced by the U.S. in deciding what these mutual interest should be than the other way around. This is all the more reason the United States needs to

undertake that exercise to determine what we should expect from the bilateral relationship.

Ron has asked the question "Do we want to live under a Japanese empire?" This has actually been on the minds of a lot of us dealing with Japan over the last few years. I think it was in 1983 or so, *Shokun*, the large circulation Japanese magazine, had an article entitled "Is California the Second Manchuria?" Americans who saw that in 1983 probably dismissed it as a joke. But if you saw last year's *Focus* magazine—with a photograph of downtown Los Angeles showing most of the largest office buildings bought by Japanese interests—you might start to understand why some people in Japan are thinking of the bilateral relationship, at least with California, in those terms.

Ira mentioned that he thought that one of the implications of Ron's presentation was that we can't reach an accommodation with Japan. I don't see it that way. I think the implication of what Ron was saying is that we're probably going to reach some kind of accommodation with Japan but that this is not going to necessarily be in our long-term self-interest. If we reach an "accommodation" with Japan, however that's defined, it will probably result in more of a benefit to Japan than to the United States. I can think on a micro level of various exchange programs between American universities and Japanese universities, American corporations and Japanese corporations, American think tanks and Japanese think tanks, and on and on, where there is an accommodation, an arrangement of some kind that's supposed to result in mutual benefit. But in almost every instance that I can think of, the benefit goes more to Japan than to the U.S. It's certainly difficult to criticize the Japanese for that because they're basically taking advantage of what is offered to them. It really is necessary for Americans to think much more seriously about the Japanese challenge and the Japanese competition. Fundamentally, when we reflect on "Japan as a Superpower: Implications for U.S. Interests,"—the title of this panel—the first thing we need to do is to recognize that Japan is indeed a superpower, and as such deserves more attention and concern than we've given it, whether it's in education, in the media, in business, or in government. Ron several years ago co-authored an article in *Foreign Policy* that examines the bureaucratic dimensions of the imbalance, but just a couple of weeks ago, when I was in Japan for beef and citrus negotiations, we had a meeting on the GATT 12 issue that illustrates this problem. There were in the negotiating room 55 Japanese officials and 4 American officials. And that's not unusual. The amount of resources—time, commitment, money, personnel—that we devote in the U.S. government to Japan is minuscule compared to the amount of attention and resources the Japanese government deploys. But it's in practically all aspects of society, whether you look at the mass media, at education, at business, and so forth. Thus, the first and foremost implication we need to draw out of "Japan as a Superpower" is that we need a "paradigm shift" to recognize that Japan is indeed a superpower and devote the necessary time and resources and money to deal with that fact.

When Ira mentioned the importance of technology in the U.S.-Japan relationship, I'm reminded of the Science and Technology

Agreement which we spent a year negotiating with Japan and which was signed just a couple of weeks ago by the President and the Prime Minister at the Toronto Summit. Here again is an agreement where the U.S. government and Japanese government negotiated for months. After some acrimony and some controversy, we finally got included certain provisions which we think will provide access to Japanese laboratories and projects for American engineers, scientists, and researchers. But again, even if the Japanese technology centers were completely open to Americans and the opposite was true in the United States, clearly the benefits would accrue to the Japanese. I'm certain you can think of a number of reasons for that.

As a member of the Executive Office of the President and as a trade negotiator, I'm not in a position to speculate too freely about the specific trade policy implications for the United States of Japan's rise as a superpower. But I would conclude that it really boils down to what it is the United States wants and needs and expects to get out of the U.S.-Japan relationship. This is the real key. We don't, at this point, have an infrastructure or basis on which to decide that. It's not so much really a debate about Japan and what it needs to do, although that debate is important. More fundamentally, it's a debate about the U.S. and our future, and what we expect to do—what our role is in the world, and how Japan fits into that role vision.

Mr. NANTO. Thank you, Glen. We'd like now to give each of the paper presenters and opportunity to respond, if they would like.

Mr. CALDER. I'd like to respond briefly to both our commentators, but particularly to some of what Glen had to say. I think clearly there are, as he was suggesting, a lot of people in Japan who would like to take advantage of the new economic realities that have arisen. But there are a lot of cases where Japan has a very strong interest in something, and devotes a lot of attention to it. Conversely, we don't show the same sort of concern, and they end up dominating the issue area in question. That's happened time and time again, particularly with regard to some of the trade issues. But that said, I think we can't ignore basic structural characteristics of the Japanese system which give us potential advantages in dealing with them, if we're organized enough to do so. In particular, we can't ignore the dependence Japanese firms have on the U.S. market. And of course, this is more true in high tech than it is anywhere else. Nearly 50 percent of Japanese telecommunications equipment exports, for example, go to the United States. And nearly 40 percent of semiconductors. That's one point.

The other one concerns the internal divisions within Japan, which create this reactive state phenomenon I was talking about. So I think the consequence is that where the U.S. is organized and has a good sense of the issue, it has to succeed in the negotiations.

I would just take a case where Ira himself was involved. He could speak to it better than I. But this case shows both the possibilities and the problems: the telecommunications negotiations and the software negotiations. Japan had a proposal out of MITI for patent protection of software which was unacceptable to American corporations. It would have undermined copyright protection of software. Through a relatively sophisticated, and, I think, well-or-

chestrated process of both multilateral and bilateral pressure, including contacts with people like the Ministry of Education and various parts of the Japanese political world, the U.S. was able to prevent that proposal for undermining copyright protection from going forward. On telecommunications, as well, there were certain major concessions that the U.S. did get out of Japan. In the implementation of the agreement it's possible that a lot of our concessions from Japan may have been compromised, but I think the software case in particular shows us that if we have a conception of the issue, and how important it is, if we organize for it, and if we do some of the things I'm sure Glen would probably suggest should be done more broadly, then we can succeed in our negotiations with Japan. But we can't assume that just because Japan is reactive, we'll get everything we want.

Mr. MORSE. Just briefly. I agree with both Ira Wolf and Glen Fukushima that we have to get out of the couch potato consensus mentality that we have about Japan, and really begin to understand what's going on there. And it's simply a resource allocation question. With the Soviet Union, everybody who's in Washington knows what the resource allocation in this town is; stay abreast of the United States' major strategic competitor! Now the resources that we devote to that are probably more or less equal to the resources that the Japanese devote to making sure that the United States stays happy, and enjoys Japanese products. In other words, they study us. They work on it. They do the market research. Their foreign ministry, their defense department, their everybody looks at how the relationship with the United States can be managed so they come out on top. That's their top priority. Now if you look at what we do in terms of dealing with our major largest competitor, Japan, the country that theoretically is at the head of the new Asian regional bloc, the resource allocation makes it such that one cannot know the competitors; cannot know how to deal with them; cannot meet them on equal ground to negotiate what our national interest is. Some may say that's fine, but the implications of it have to be drawn out. We know what the implications would be of ignorance about the Soviet Union. That's simple. But we are not willing to—and this is a major flaw in both our tax structure, investment and R&D, our attention to economic problems, and our attention to our major competitors—or have not been able to shift out of the big power mentality on strategic issues to examine how the implications of Japan apply to economics. We're fighting the Soviets who also don't care about their economy, up until recently. Their concern was strategic issues. The Japanese are not concerned with strategic issues. They're concerned only with economics. The United States has had to be concerned with both. We've decided on a resource allocation system that neglects one to the benefit of the other. Full attention to Moscow, ignore Japan. The question is how long can we go on with that type of a setup.

Mr. NANTO. We would like to turn now to questions from the audience. We'll start with Erland Heginbotham.

Mr. HEGINBOTHAM. Thank you. I'd like to follow up on this last point which I think is a very intriguing, a very fundamental one. We've always spent a lot of money on war and never spent much money on peace, which is another kind of parallel. There was a

recent survey which indicated that some major percentage of Americans now see the greatest present threat to our security being in the economic sphere. Now the American public has realized this threat—my question is really addressed to Ira—Is there any chance that this recognition by the American public will show up in causing the Congress or the political leaders during the election to acknowledge that same concept—and perhaps shift some resources and attention to the challenge to our economic security.

Mr. WOLF. I just happen to have the statistics right here [laughter]. The two questions that most people have seen come out of a very large, 5-volume study on national security. The question: Which is more important in determining a country's influence in the world today—economic or military power? Answer: economic power, 62 percent; military power, 22 percent.

Question: Which poses a greater threat to U.S. national security—military adversaries like the Soviet Union or economic competitors like Japan? Answer: Japan—59 percent; Soviet Union—31 percent.

The reason I decided not even to mention this study was in my remarks that there is a difference between responding to public opinion of the day, and the needs of policy-makers or politicians who want to lead and manage an issue. You have to be very careful with those statistics. Maybe the beef and citrus issues are part of this. I don't know if these figures represent a dramatic change in the American public's understanding of the world so much as the result of several years of Gorbachev, the Soviets pulling back, no great tension, no saber rattling versus lots of Hondais, and lots of Samsung VCRs and the like. I tend to think it's the latter, not the former, and I don't think these statistics are something that should be used to make policy decisions.

Mr. HEGINBOTHAM. So you don't see it translating as a rising interest or concern on the part of politicians?

Mr. WOLF. It clearly is an increasing rise. The trade bill, the votes for the trade bill, the almost override of the trade bill in the Senate, and the overwhelming vote in the House, but I don't know if that is enough to change the policy-making mentality still pervasive in Washington.

Mr. NANTO. Ed Lincoln?

Mr. LINCOLN. I want to make two quick comments to reinforce things that were said up here. Ron has mentioned the deplorable lack of resources that we put into studying economic issues and studying Japan. Is the situation so bad that many of the few resources that we have on Japan are paid for by the Japanese and not by ourselves? This is partly because the Japanese would like to think that they could influence a debate in the United States that way, and partly because nobody in the United States will pay for it. Universities around this nation that want to have a program on Japan cannot find money in the United States. The corporate sector is not interested, so the money ends up coming from Japan. It may not influence their research. It may not necessarily influence the attitudes of the students, but you would think if we thought Japan was important, we at least could put up a little money to learn about it.

The second point I want to make is that I was at a meeting yesterday where I saw a very interesting projection. I haven't had time to go back and check just exactly how accurate this calculation is, but the implication was that if the United States does not change its macroeconomic policies, foreign ownership of American assets rises to 30 percent by 1995, which is beyond our historical experience. We had a lot of foreign ownership of American assets in the late 19th century, but the peak then was about 20 percent, and it was a big political issue. We're talking about going well beyond that. We're talking about belonging to the Japanese empire. We're selling the country to them. If we don't change our macroeconomic policy, we'll continue selling the country to them. It's not their fault.

Mr. NANTO. Any response to that?

Mr. FUKUSHIMA. My response is more to the first point rather than the second point, but I would just corroborate what you've said by indicating that a reason why I'm not very encouraged even by the poll data Ira cites is that, first, my office at USTR gets something like 50 or 60 publications in English and Japanese on a weekly or monthly basis dealing with U.S.-Japan issues or Japanese economic issues, and all except two or three of them are from Japanese sources. Second, when I joined USTR three and a half years ago, I was appalled to find we didn't have any Japanese-language newspapers. I put in an order for Nihon Keizai Shimbun (the major business daily), but it was rejected by our budget office which said that \$80 a month to get Nihon Keizai Shimbun by airmail was too expensive. Third, last year when my wife was in the MBA program at Stanford, she told me that in her second-year International Marketing course 80 percent of the students were foreign students. Only 20 percent were American students. It's discouraging to learn that so few future captains of industry in the U.S. are interested in international business.

Mr. NANTO. Kent?

Mr. CALDER. Enough said.

Mr. NANTO. David Hitchcock from CSIS.

Mr. HITCHCOCK. Everyone says that we don't have a global strategy. It seems to me that it's necessary for both countries to try to explore their global strategy together rather than to try to establish it separately, and that's the purpose of the broader consultation. I don't think that broader consultation will get you away from sector specific or product specific trade issues, and even if you accomplish liberalization of all remaining restrictions, you still have the basic issue which is that Japan in many ways remains—operates in a way that is unique. I won't say it's closed, but it operates in a way that is difficult for the rest of the world, not just the United States. And if that doesn't change more radically, no political situation in the United States is able to permit global strategy discussions to go on without bringing them right back to those specific economic issues. So you can have global strategy, and I think we should. Discussions with Japan to try to establish what the goals are for us both together rather than separately, but somewhere along the line you're still going to have to deal with realities of political pressures in the United States, and indeed, if those pressures weren't there, we ought to be seeking a wider opening

and more international behavior by Japanese business at home in any case. I think that interdependence is a bigger problem for us than it is for the Japanese. And we need to look within ourselves in the country to see whether interdependence is something we are prepared to adopt and accept. While we have trouble accepting interdependence, the Japanese resist real independence—they are not used to it.

Mr. MORSE. Let me just say two things. One of the nice surprises of coming to the Library of Congress has been that a rough survey of the resources in terms of people with Japanese language competence in the Library of Congress leads me to assume that more or less the Library of Congress alone has almost all the same level of competence as the rest of the whole Executive Branch in Japanese capabilities. That's one thing we can be proud of up here. It's not being used for the right purposes perhaps, but it is here.

I'm not advocating more confrontation, just the opposite. What I'm advocating is that we don't try to fool ourselves about what the nature of the issue is. And I think if we were to have a clearer sense of ourselves and how Japan fits into our plans, that there would in fact be less confrontation. The reason I think there's so much so-called confrontation now, which isn't really major confrontation, but it's the kind of creeping confrontation that poisons the well, is that we have basically ignored Tokyo or allowed the Japanese to solve our problems. If you look on any issue—automobile quotas, semiconductor agreements, tobacco, beef and oranges—what the United States has done is asked the Japanese to somehow work through their system in accommodation to our policy. And what we have done is we've been the bad guys pushing it down their throats. Now I think if we had a sensible policy that clearly defined objectives and sanctions, we wouldn't have to tell the Japanese what to do. We would suggest to them what they would have to do and what the consequences are, and let them work it through their system. A guy like Takeshita is hiding someplace in Tokyo, nobody knows what he's doing, but he is delivering, and that's the way it should be. The Japanese should decide what's right for them and they should pursue it. And if they make the wrong choice, they get burned. If it's right, they get rewarded. But we shouldn't be in the process of surrendering, allowing them to allocate quotas to the United States for Japanese automobile exports, and we shouldn't allow them to control quotas on how much we export in beef and oranges to Japan. We should just tell that here's the name of the game, you don't that, there's a reciprocal way of handling that. But we'll handle our market; you handle your market. You solve your problems; we'll solve our problems. And it just has to be a clear set of rules about how that works.

Mr. ALBRECHT. Well, a followup on that—my memory of working on this issue in Japan was every time you did that you ended up with the Japanese saying, well, be more specific. What is it you're really talking about? They always wanted to get right down to the product.

Mr. MORSE. Yeah, but the trouble is that instead of saying, this is as specific as we're going to be, figure it out—what happens is we try to then figure out some gimmick to accommodate them.

Mr. ALBRECHT. Well, gimmicks are necessary because people don't want to go to jail on the U.S. side. In terms of your antitrust and other laws, you can't conspire to deny U.S. consumers goods without having some sort of negotiation. My point is this, I think the quintessence of this discussion seems to be that we are frustrated with the Japanese because we can't get organized on our side. It seems to me we've got to face that. We're talking about it right now—we don't have enough resources. We've loaned them to Japan. Well, what do we do with it? The Japanese are trying to help by financing the study in Japanese language and so forth and so on. We do not have a high enough priority on any of these issues. We don't have a system which gives leadership to the president or the trade negotiator. You go out and set the trade agenda. We have all kinds of special interest groups who apply their pressures on Congress and different things pop up as priorities. And the Japanese, their system has a way, slow as it may be, reactive you could call it, but at least they figure out what their national interest is and how to pursue it. So it comes back again to how are we going to do that? Here is one practical consideration. The efforts that are put into defense of specific trade issues and the efforts of congressmen and senators pushing for particular constituencies—could be channeled into a stronger response if we could get a grip on our real trade interests, that might be more of a solution than picking up bits on the trade hill. I don't think this is going help matters that much.

Mr. NANTO. Any response? Yes, Kent Calder.

Mr. CALDER. I just have to add one point regarding the dynamics of negotiations. It really strikes me that it's important to preserve the structure whereby we make the demands and the Japanese react. A lot of times we haven't been sufficiently strategic in what we've been asking for. But we have an immense tactical advantage in the current structure of the negotiating process, if we would use it more effectively. Of course, if we were to ask for things that were a little harder for Japan to deliver, then they might want to be more assertive in formulating counter proposals. That might be one way to proceed, but I think we do have a tactical advantage in the structure of the negotiating process that we should preserve rather than waiting for them to come up with a set of proposals.

Mr. WOLF. We're also at a great disadvantage because we have this hangup on something called a level playing field, even-handed, fairness. A couple of hours ago, I was with 25 Japanese businessmen, middle-level managers, talking about the problems, and I gave them an even-handed approach: here are the problems in Japan and here are the problems in the U.S. And they spent the time telling me about the problems in the U.S. To them, there are no problems in Japan. How do you negotiate with that kind of a fundamentally different approach on the two sides?

Mr. NANTO. Bill Barnds?

Mr. BARNDS. Ron spoke about the allocation of resources. What is more striking is that the people that are getting hurt first and hardest—U.S. businessmen—aren't allocating resources to dealing with Japan. If they were to allocate the resources or try to, that would create much more demand for Japanese studies in the schools and the universities. Now, obviously if the government allo-

cates more resources, then that will have an effect too. But the behavior of corporate America on this is much more puzzling, and in a way, much more troublesome than even the behavior of the U.S. government.

Mr. MORSE. The only thing I would say to that is I think the Japanese have been very successful in convincing people in government and in the private sector in this country, that, for example, in beef and oranges, they've been able to go to each state level and convince people that their quota is really to their benefit, and if they shake the boat, the Australians, or the Brazilians, or somebody is going to get their piece of the action. So our officials don't shake the boat! They've really allocated tremendous resources to buffering our people. American companies in Japan don't shake the boat because you know you've got a nice little niche in the Japanese market. Even if it's tiny, it's very lucrative. They've been able to do that and work this dependency relationship that I elaborated about a little bit more in my paper at all levels in our society. And one only has to see what happened, for example, on Toshiba or other cases—automobile export quotas, and so on—to see that the battle on these issues is no longer in Japan. The Japanese have shifted the battle into the private sector in the U.S. and into the government agencies in this country where they fight each other on how they're going to deal with Japan and pretty much destroy each other in the process, and the issue never goes back to Tokyo anymore. It used to be that we took problems there and fought them. Now what's happening: the battle zone is actually shifted and we have constituencies and because of our interest articulation process, and because of subcontracting relationships. And what they're building at several levels and now I think at a much higher level—in the past it was in certain particular areas, certain industries, and so on—but what we're seeing now the Japanese are articulating these broad, generic, sort of pax consortia that are ideologically satisfying, in that everything else is working fine guys, and now all we have to do is agree to carve up the world between the two of us, and you take care of one little part of it, and we'll take care of another little part of it, and together we're going to have this great co-prosperity here in the Pacific. Each stage in the process the scenarios have changed, I think, over the last 30 years, as somebody—I think it was the speaker who spoke about the developments in the four Asian NIC's—the 1970s were different; the 1980s are different, and the 1990s will be different. We have not taken a careful look at the process. I think you suggested, Glen, we're not looking at the process of how this relationship is changing. Ten years ago, Japan was dependent on us for imports. Today we're dependent on Japan for imports. That alone in terms of the shift in power relationships is something of a fantastic magnitude in terms of leverage. So we're not looking carefully at how this process is evolving and what the implications are, and all I'm suggesting is that we consider a little bit more carefully, because we are being woven into a fabric of interdependent relationships that comes so easy and have come so naturally that we're not consciously thinking of them in terms of overall global strategy. Maybe that's the function of a declining power is to be woven into somebody else's fabric.

Mr. WEINSTEIN. I would like to commend Kent Calder because in his paper he hardly—referred to Japan as a superpower. He described their economic clout and their capabilities, but avoided this term. I'm all in favor of allocating far greater resources to dealing with Japan and to dealing with American economic problems, but I'm afraid that we're really going to do this in the wrong way, if we have to turn Japan into an economic enemy, and somehow go into a mobilization. I don't think it's beneficial to our own interests to think of Japan that way. I would sum it up this way: the idea that Japan is building some kind of empire, of which we may become a member, seems to me just to be completely out of the picture. It just doesn't address the real issues at all.

I think it would probably be a very good thing if the United States Secretary of State picked up the phone now and then and called Tokyo as well as London, Paris, or Bonn before he made a major foreign policy decision. The idea that we can continue to run our foreign relations as though we are the Hegemon and simply decide things in Washington and carry them out and others react, is the height of unrealism. So I wouldn't mind, Ron, if we started picking up the phone even now. We don't have to wait 10 years. I think we should probably have done it at the time we recognized—we opened relations with China back in 1972. We're way behind on this curve.

Mr. NANTO. Ruth Kurtz from Senator Roth's staff.

Ms. KURTZ. I'm quite interested in obtaining more specifics on the answers to some of the issues raised here. Glen Fukushima talked about the idea that the United States needs a better structure to decide what it wants to do. And I think almost each of the other people talked about defining our objectives better. I want to know how they think we should go about doing that.

Mr. CALDER. Not being directly involved in this, perhaps I have a little more freedom here. I strongly believe that we should focus on high-technology and other growing sectors in our negotiations. In many cases, the markets are growing more rapidly and it's always easier to liberalize if things generally are in a state of flux or the market in general is growing, since positive sum rather than zero-sum relationships prevail. We find most of the U.S.-Japan trade frictions relate to depressed industries, and so it seems to me both in terms of the costs and in terms of the benefits, that making high-technology a real priority is one thing specifically that we could do.

Mr. MORSE. Let me just say—the question you asked is the right question, and the answers are always reluctant simply because they know the constraints. So I think to get a good answer to the question that you asked, there have to be several different levels of consideration. At one level one has to sort of project what would be the ideal situation. In other words, if we had a strategic planning body in our government which we do not have, how would Japan along with every other country be treated in some type of systematic and thoughtful way so that U.S. maximized its national interests. I think what some people have been saying is that our national interest is our economy. If that were the case, and I think a couple of the speakers this morning said it, we should have a very aggressive policy on exports and trade with the Pacific Basin. That

is the way Taiwan does it, and Korea does it, and Japan does it, and that would mean almost a mobilization society where the private sector would be given top priority in our national tax and other benefits. However, that's the ideal situation. Then one starts backtracking down the line to what the Executive Branch is capable of, what the resources are, and then what Congress will do in that context.

I think the question is the right question and I think it's going to take some very high-level thoughtful consideration across the board—Congress—almost everything that happens in the Executive Branch, Congress is excluded from. The debates on the Hill, the Executive Branch ignores. When you have your two basic—just as an example to answer a piece of your question: what would you do—I mean this is true across the board, but we're talking about Japan—I would say that the U.S. Congress should have at least two people on every bilateral negotiating team that goes from the Executive Branch with Japan. Congress should not be excluded from the debate. It has to know what's going on. I would say there should be at least five people in the U.S. Embassy that work exclusively for Congress, answering their requests, collecting information, and working for them, and handling the delegations, instead of letting disgruntled Foreign Service officers, unhappy with Congressmen, set them up with the wrong people. So there are a lot of simple things that could be done but it's going to take some people with one, vision, and two, guts. And we haven't found those people around here yet.

Mr. WOLF. I personally think that rather than a reorganization, we need a different kind of structural approach in the Executive Branch to Japan. I'll use the way we deal with the Soviet Union as a parallel—not the adversarial aspect but just the kind of integrated focus we use in policy-making. We've got a large number of groups and levels and layers in the Executive Branch to deal with START negotiations, with arms control, with Soviet policy. We have nothing parallel to that with Japan policy and I think it's just as important to the United States that we have such a process. We need a central focus, a way to move Japan policy out of the political pressures, a restructuring, at least in the Executive Branch. I'll withhold on Ron's congressional suggestions.

Mr. NANTO. John Bennett.

Mr. BENNETT. A couple of points—one, I'm just astonished at this paranoia about the Japanese. Where are you guys coming from?

Mr. MORSE. They're front men for the Koreans [laughter].

Mr. BENNETT. I would also claim American citizenship, and having served in a few countries which were not so successful. Look—you go back to the macroeconomic policy issues and you go back to import of capital, a high dollar, a relatively high dollar even now, and a trade deficit, and it just goes together. And if the trade deficit were done away with, if we didn't have the trade deficit, most of these issues that you're having such trouble about, would be much less difficult. We wouldn't be worried about them so much. You start there.

There's another part to this. No American business trying to sell in Japan with a high dollar is going to spend a nickel on looking at that market or on hiring Japanese or paying for people to study

Japanese. I wouldn't, because I'm not going to get anything—no payback on it. Get the macroeconomic policy right and then we can begin to do some of these other things. Otherwise, if you fiddle around with special programs, you train Japanese scholars whom nobody is going to hire, except the Japanese; if you fiddle around putting money in R&D or DRAMS so that some other industry gets socked in the teeth, you're going to end up with the same dumb trade deficit and the same problems we've got today. Do something about the macroeconomic policy. That's where you start. Then you can do some of these other things. I think our relationship with Japan is pretty good.

Mr. MORSE. I think you're the one that's paranoid. I think what we're trying to say is that because people are trying to say what the United States stands for, the kind of world that we've articulated in the postwar years, the kind of policies the country's had, what it has done for the reconstruction of Japan and Europe and all the rest of it, and the principles that a lot of people think it stands for, is something that comes free, and you just have to sit back and adjust macroeconomic policy is nonsense. It's based on a philosophy and a whole set of issues. Just because one has a macroeconomic problem to say that there then aren't other issues that one considers and also that because we have a national interest and some people think that we should be number one in every area still, as we were in the past, and that we can do it, and that we have the resources to solve both the macroeconomic problem and other problems, and then to jump to the conclusion that therefore somebody is "anti-somebody" is the wrong jump. You don't have to be anti-something to say that you should deal effectively with a problem in a sensible way. If it's cancer or if it's another problem, if it's a macroeconomic problem, there are strategies to deal with things. All we're saying is that resource allocation, the attention to the problem, and the seriousness with which you treat it directly relates to how successful you are in solving the problem. And that's all we've said. We haven't attacked Japan. What we've tried to say is that Japan is pursuing a certain group of policies that are very effective. They work well because they operate on principles that make it so they can do it. This is true of other Asian countries that are having large trade surpluses with us. We've been trying in this country through various multilateral institutions to correct that to some extent. Maybe we're doing it the wrong way. Maybe it's not working. But you don't give up the game simply because somebody feels that they're being picked on. I think that's a totally wrong reaction.

Mr. CALDER. Just one clarification. The macroeconomic problem put by another name is national defense. If we take away the defense spending of the two countries, Japanese budget deficits are larger than those of the United States by a significant margin. So of course we get into much more fundamental issues. We have to operate subject to a set of constraints, I suppose, and if we're not going to reexamine in the course of our macroeconomic analysis our entire global defense posture, then we have to deal with perhaps smaller issues that are more tractable.

Mr. WOLF. And I think perhaps the trade deficit focused the attention of a lot of people and highlighted the fact that there were

problems. But getting underneath it, the trade deficit has nothing to do with the science, technology challenges or problems between Japan and the U.S. over the next 20 years. It has nothing to do with how we deal with the Korean peninsula and strategic issues, security issues, in Asia. It has nothing to do with how we deal with Third World development problems. I think there's a whole range of issues there between the U.S. and Japan—potentially confrontational issues, potentially cooperative issues—that have nothing to do with the trade deficit, but which have to be resolved between us.

Mr. NANTO. We're running very short on time. Let's take a couple more—Lee Price from the Joint Economic Committee.

Mr. PRICE. Just to further underscore that response to the macro-economic issue. I think that Japan has emerged as a major power. This is an important subject to talk about. And even if we get our macro problems fixed in a hurry, Japan's surpluses and the power that flows from that will give them certain power into the future that is worth considering. But I was kind of puzzled that there wasn't more discussion of this by Kent and Ron. But I heard Glen talk about the younger generation having a different perspective, and I've heard Jay Rockefeller talk about the younger generation, having a different perspective on Japan's role in the world. And instead of talking about the next couple of years, we talk about Japan of 10 years from now, when presumably that younger generation is in power, or has more power than it has today. What kind of role do we see then? I would say that part of U.S. power in the last 40 years has come from our having capital to mobilize or having a big market that we could invite imports into, and we're not going to be in that position for a while and Japan is. We go to negotiate with the Philippines on bases and they look at what Japan is doing for them without any bases. And the U.S. has to do that much better, and so our relations with much of Asia are going to be affected by the fact that every country is going to compare what the U.S. can do with what Japan can do. Our power is going to be affected by a fix we've gotten ourselves into. So I guess I would like to push the panel to look at more than the next couple of years. Do you think there might a break in the way Japan perceives its role in the world, and if so, how should we be reacting to that hypothetical change?

Mr. MORSE. I think there could very well, that's why Kent was saying 5 to 10 years. I think we may see a discontinuity perhaps 10 years hence. That gives us some length of time to plan. Many of the internal divisions within Japan will continue and some of them will intensify, but I think that 10 years hence in order to preserve some semblance of the current system, we will have to in a sense play Japanese domestic politics the way they play our politics, in order to preserve an equitable relationship.

The generation born after World War II is currently slightly under 40 years of age. This is the generation that will be in power for the next 40 years essentially—20 to 30 years, until they're 60 to 70 years of age. Basically the people today who are writing the policy formulations at the lower levels in the Japanese bureaucracy today, the one who more than likely have studied in the United States for a couple of years, speak English a lot better than the earlier generation, have grown up in a very affluent society—given

what their parents had experienced—people who have an elite sense of being technocrats; many of them are yuppies of a kind. These are people who don't remember World War II necessarily. They're people who feel that they've done it on their own, that Japan has certainly had benefits from various countries, but they've seen how their elders have really struggled to accomplish what they've done. The sense of indebtedness to the United States is probably less. They are much more professional in how they'll pursue their interests. They are likely to have a strong sense because of the generational change of Japanese sort of a different kind of nationalism. It's going to be a much more hard-core type of nationalism as opposed to an emotional, prewar-type of nationalism. Several Japanese of the older generation—you have to realize that we today up to the present, including Takeshita, there have only been maybe 50 people, all grew up in prewar Japan, that have managed Japan since 1945. Nakasone, all of them—kamikaze pilots of one kind or another or something or the other in the prewar period—have been in charge of all their factions for the last 40 to 45 years. These are guys—if you look at the turnover just in our system, and you say, what are the changes in the Japanese. Take somebody like Okita Saburo, set up power plants in Manchuria in the prewar period, came back to Tokyo as an economist, came to the United States, studied at the White House in the 50s, learned all the macroeconomic policies, went back to Japan and today is the floating guru around the world on Japanese economic affairs. He's been in charge. In 1946 he wrote a policy paper on how Japan should recover, how it should avoid militarism, and what it needed to put in place. If you read that document, it's almost as if was planned that it would come out the way it has today—not that it's that direct, but basically the guys who were in charge in 1945—after the top was cut off and some of the criminals were gotten rid of—that second or third tier of technocrats are the ones who have engineered the whole postwar period. That's going to change in the next 5 to 10 years. And they'll all be gone, probably by the turn of the century. Many ways their generation doesn't approve of any militarism. They've been internationalist in perspective, close to the United States, and they have a very particular mind-set, and they've built this postwar period. Now what's going to happen in that transition to the younger generation? I think you asked a very important question, because, first of all, we don't know who's going to be in charge in the United States, but there's no question that a different generation, with a very different perspective, different set of loyalties, global experience, lots of information, lots of knowledge are going to be calling the shots in Tokyo. I have a feeling that they are going to be people who are going to be harder to deal with than the generation we've got in place. And if we've been screwing it up with the guys who are so-called on our side, what's it going to be like with the other guys? [Laughter.]

Mr. FUKUSHIMA. That's precisely the point I was trying to make. In my conversations with Japanese government officials in their 40s or 50s, they say, "If you think you have it hard now, wait until these guys in their 20s get into positions of leadership in the Japanese bureaucracy." So I agree completely with Ron in that regard. And I think it's all the more reason why the U.S. has to get its act

together. Otherwise we're going to be in a real fix, more so than we are now.

Mr. MORSE. Let me just add for those people who have been to Korea, which has even a more highly trained, American trained, elite and more people in government that speak English. And you go to Taiwan and you look at the elites there, and you go around to the other countries in Asia. We have trained and reexported all kinds of economists, engineers, and planners. I mean the people in Asia that today are in almost all the key positions are people that have extensive experience in the United States and follow what we're doing very carefully. And it's not because they're adversarial. It's because for the whole postwar period, through exchange programs and all these things, we have trained the people out there who are the real professionals. We deserve credit for it, but we have to realize that those guys know how to play hardball on our terms.

Mr. FUKUSHIMA. Could I just add one point? I sense that among some of the members of the audience there is a sense that the panelists are overreacting to the Japanese challenge. I want to remind you, having been an academic myself, that Americans who deal with Japan as academics or from foundations or nonprofit organizations or in other areas where the Japanese do not necessarily perceive a zero sum game, the way the Japanese treat those people is very different from the way they treat people from the United States who are in business or government. And so I would just like to leave you with this thought: How you're treated in Japan and your perceptions of Japan can be dramatically different based on your position and on who in Japan you deal with. Even among U.S. Government officials, if you're dealing with Japanese politicians, journalist, and academics—as do some people working in political affairs related to Japan—you are likely to have a very different view of Japan than those of us who daily contend with the hardened bureaucrats whose lifelong mission is to protect their interests, their careers, their ministries, their industries, and their country.

Mr. NANTO. Well, on that very positive note, we'd like to thank our panelists. We'll take a short 5-minute break.

PANEL 5.—SECURITY ISSUES RAISED BY THE EAST ASIAN CHALLENGE

DISCUSSION LEADER: Michael W. Chinworth, Program Associate, MIT-Japan Program on Science and Technology, Massachusetts Institute of Technology

COMMENTATORS:

Ellen Frost, Director, International Affairs, United Technologies

Thomas W. Robinson, Director, China Studies Program, American Enterprise Institute

MODERATOR: Larry Niksch, Specialist in Asian Affairs, Congressional Research Service

Mr. NIKSCH. I'm Larry Niksch, Specialist in Asian Affairs with the Congressional Research Service, and I'm going to moderate this panel on Security Issues Raised by the East Asian Challenge. I think that if one looks at the early to mid 1980s, we see a period in American foreign and security policies in which East Asia did not figure very highly in the high-level policy decisions of American policy makers. But I think this is now beginning to change. There

are a number of security issues which are clearly emerging in the Western Pacific that American policy makers are going to have to give very high level attention to in the future.

As a framework for some of the things we may talk about during this panel, I will list some of the key issues. There's a category of issues affecting the U.S. military presence and security commitments. We've talked about the pressures on the U.S. budget, especially the defense budget, that could affect U.S. military force structures in the future; the demands for burden-sharing that Americans increasingly are making on our allies, and the growing emphasis on financial contributions. Some of the things that Ira Wolf talked about in a defense appropriations bill, I think, highlights the trend in the U.S. definition of burden-sharing.

We now have the rise of anti-U.S. nationalism or broader strains of nationalism and resentment about U.S. policies in a number of allied countries in East Asia. And these resentments have begun to grow out of American pressures on these countries, on trade and burden-sharing. Certainly, we're seeing this at a very high and vocal level in the Philippines and in South Korea today, and that could affect very strongly our future security presence, but we're seeing it in a number of other countries as well.

There is the future security role of Japan and the ambivalence I think that we have discussed in the United States about what that role actually should be and what does it mean in terms of the U.S.-Japan relationship in the future.

There is now a new Soviet, at least tactical, presence in East Asia under Secretary Gorbachev. Soviet-style and Soviet diplomacy has shifted markedly from what it was under Brezhnev. The Soviet agenda features negotiations now, proposals for nuclear-free zones and possibly in the future, high-level proposals for arms reduction in the Pacific. The Soviet military buildup does continue but Soviet diplomatic style and Soviet policy in many ways has shifted and has produced a favorable reaction on the part of a number of the nations in East Asia.

Finally, there is China, which has a potential impact on all of these issues. And I think the future Chinese role in some of the problems that perhaps may be associated with that role were demonstrated by a relatively unpublicized event in this country—the movement of Chinese naval and marine forces into the Spratley Islands in the South China Sea and the occupation of a number of the islands in the Spratley's by the Chinese—a rather dramatic and I would contend under publicized event that took place in March of this year.

To address some of these issues, I would like now to turn to Michael Chinworth from the Massachusetts Institute of Technology. He is a program associate there with the Japan Science and Technology Program. Prior to going to MIT, he was the vice president of the Japan Economic Institute here in Washington where I first came to know him and worked with him in that capacity. Michael was educated at John Hopkins University and the University of Notre Dame. In addition, he has studied at Japanese universities on two different occasions in the 1970s and is proficient in Japanese.

STATEMENT OF MICHAEL W. CHINWORTH, PROGRAM ASSOCIATE, MIT-JAPAN PROGRAM ON SCIENCE AND TECHNOLOGY, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. CHINWORTH. Thank you, Larry. I'm very happy to be here at the first annual reunion of former vice presidents of Japan Economic Institute. I trust the budget will not preclude us from having the second meeting next year on schedule, and I'll even offer Cambridge as a possible site. [Laughter.]

I've got to confess to a great deal of discomfort being here right now, for a couple of reasons. The first, and this is not false humility, if I know anything at all about Asian and Japanese security policies, it's largely because of many of the people in this room. And I feel a little bit presumptuous making any statements in front of these people, who have been the source of whatever knowledge I have. The second reason for discomfort is because the last panel was a pretty tough act to follow. What I would like to really propose here that we dispense with this particular session. I'm sort of a boxing fan and I was disappointed by the minute, 31-second fight Monday night. So what I'd like to propose that we set up a ring here and get Ron Morse and John Bennett to go 12 rounds. I have a sneaking suspicion it would last for more than 1 minute, 31 seconds. [Laughter.] Now, if you won't take me up on that offer, I will just plunge ahead for a few minutes and outline a few thoughts, and then let the experts fill in the substance.

I would like to focus today on, the American approach to security issues in Asia and how that affects our working with Japan. There are three reasons for focusing on Japan. The first reason, as has been suggested throughout the day, is because of the economic, political, and military importance of Japan to the United States. The second is because of the unique role that the United States has had in shaping Japanese military policies over the last 40 plus years. And the final reason is because of Japan's very controversial role in the ongoing burden-sharing debate.

I think Larry defined many of the important issues very succinctly. What I'm going to do is just assume that we all know about the nature of the arguments about the Soviet presence in Asia and how that complicates the American policymaking considerations in terms of defending our economic, political, and military interests in the region. However, what I would like to suggest here is that there's not necessarily a complete identity of interests or even definite perceptions of threats between the United States and Japan in terms of these defense and security issues. What is developing in Asia is a situation whereby the United States identifies the Soviet Union as a military threat and goes about the process of trying to put more ships and destroyers and carriers to offset what it perceives as the number one threat. Japan is willing to go along to a certain degree with the definition of the Soviet Union as the threat, but is going about a different process of making itself secure vis-a-vis that threat. In the long run, the Japanese approach to security may very well be damaging to American interests.

The paper I've submitted describes some of the bureaucratic considerations in defense and security policy making in Japan. Defense in Japan is a subcomponent of overall security policy, and for

a variety of reasons—including bureaucratic interests and the nature of the defense relationship with the United States—economic linkages in Japan to defense issues are very, very strong. I do not think it's an overstatement to suggest that Japan defines its security in terms of its economy. This economic bias can be seen in the nature of defense and security policy making structures, in which several ministries and agencies play a role, and it's not any surprise I think to Japan watchers that the Japan Defense Agency is not the most important security policy making organization in Japan. Other ministries play a very, very important role including, of course, MITI, the Foreign Affairs Ministry and the Finance Ministry.

Given this situation, the United States must be very, very cautious in the development of its security relationship with Japan, its policies in Asia and the defined roles for Japan in fulfilling those policies, because inevitably they will invite significant economic tradeoffs for the United States. For example, we want Japan to spend more on defense. We want Japan to have more fighters, more interceptors. Well, that's going to mean inevitably that Japanese domestic industry is going to try to find ways of securing that business. We want Japan to spend more on aid in Asia globally to make the world more secure. The end result of this will be economic assistance policies which are different from security assistance, and economic assistance from Japan that is in practice heavily tied, heavily directed to Asia and will result in potential loss of markets for the United States throughout Asia.

I'd like to emphasize the aid theme in particular. I don't think that in the current burden-sharing debate we should huff and puff about Japan spending more aid, because I don't necessarily think this is the best approach for the United States to pursue. It is not in our interests to lose markets in Asia. It's simply too important a growth area to allow this kind of division of labor theory that is developing in Japan to come to pass. So what I would propose is something of a policy punt. It's a continuation of present defense policies with the emphasis on maintaining the American role as the pivotal role in the formulation of policies and in cooperation with allies in the region.

Let's discuss some of those policies. The first as I mentioned is efficient development assistance and other forms of Japanese aid. I would encourage this, but only in the context of strict cooperation with the United States, to assure that there really is a strategic impact of Japanese aid in the sense that the United States perceives security. I would propose that Japan adds a new category of strictly security assistance to its overall aid program, and what we're talking about here is not economic infrastructure projects that ultimately will go to Japanese construction companies, but training, communications, and perhaps even weapons procurement financed by the Japanese government. And I add here that because of Japanese arms export policies, I assume that Japanese arms would not be candidates for fulfilling these kinds of programs.

We've managed to establish a fairly successful ongoing relationship in the defense area through working level consultations—the annual defense subcommittee meetings in Hawaii are, from what I understand, head-knocking sessions that can be very, very intense,

but they have clearly enabled the two countries to define the roles and missions of both parties in making Asia more secure for both. I would emphasize continuing these kinds of consultations and broaden them to include any range of topics, including the topic of economic and security linkages. It's about time that people in the Defense Department broadened their concept of security, even beyond the ongoing debate about the industrial production base. I would contend that is far too narrow an economic focus for the Defense Department to pursue. I think we should widen it up to include a much more comprehensive concept of security.

Furthermore, I would duplicate those working level consultations wherever possible with other American allies in East Asia. Try to create a situation where you have essentially mirror images of the U.S.-Japan relationship with the Republic of Korea, to the extent possible, Taiwan, certainly the Philippines, and other economic powers in the region. I would also encourage this attempt to achieve multilateral defense cooperation through expanded training and practice exercises. There was an instance a couple of years ago where the United States essentially achieved a trilateral exercise among Japan, the United States, and the Republic of Korea, by having simultaneous bilateral exercises between the United States and Korea, and the United States and Japan. In effect, we had a trilateral, military exercise that managed to sidestep all the political problems associated with direct cooperation between South Korea and Japan. Furthermore, it strengthened the American role as the key player in the region, and that's the important consideration here. The United States must look at other means to define the nature of cooperation, to define the nature of the security situation in Asia, and to make sure that vision is shared by Japan and by other powers.

I would put considerable emphasis on making sure that the 1983 Technology Transfer Notes fulfill some of the promises that were issued at the time, and here I'll defer to Dr. Frost to elaborate. This is a critical area, and again rather than leave the initiative to someone else, the key consideration here is to identify specific technologies that the United States needs and go about acquiring them in a very, very pragmatic fashion. It's our responsibility to a large degree to make sure that those notes work. And as a subcomponent of this particular policy recommendation, I would also urge that the American schizophrenic attitudes towards Japanese investment in this country be clarified one way or another, and that especially applies to Japanese investment in companies that are considered essential to the national security. I would argue that one of the most damaging incidents in U.S.-Japan security relationships over the last several years was really the Fujitsu-Fairchild case. That sent as many negative signals as possible to Japan and it's those kinds of incidents that really undercut the potential for cooperation in the region.

And finally, it is important to recognize these economic tradeoffs. The United States really can't have it all. The United States cannot tell Japan to defend its sea lanes to 1,000 miles and then be shocked when someone in the Japan Defense Agency suggests that maybe the country needs a small aircraft carrier or helicopter carrier. The United States cannot have Japan spend 3 percent of its

GNP on security whether it be military and/or economic assistance, and then be upset that Japan gains from it economically.

We really have to pursue a course where we minimize the potential negative economic impact of policies to the United States but at the same time maximize the Japanese contributions. So for a start, what I would propose is for the Japanese government to pick up 100 percent of the costs of maintaining U.S. forces in Japan. That would be a considerable financial contribution. It's something where the precedents are fairly well established. There are some legal complications there, but I think they're surmountable, and in the meantime it gives us a little bit more time in the United States to define other areas where we can pursue our interests and achieve cooperation with Japan in Asia.

I will add one further note. Here I plagiarize Martin Weinstein and others. The flip side of these policy recommendations is the United States' responsibility. What I'm trying to argue here is that for many years we've been debating in Washington about whether a trade-defense linkage exists or is desirable or is not desirable. I think we need to go way beyond that. I'm suggesting that an economic security linkage has existed from the very first day of the occupation. Our arguing about trade-defenses linkages misses the whole point. Consequently, on this domestic side, the United States, in order to maximize its moral authority with Japan, must focus as well on domestic economic revival. This is an absolutely essential element of this security strategy, and we've discussed some of the fiscal macroeconomic policies that need to be addressed. I would add to that the absolute imperative to reduce energy consumption in this country. We talk in the security area about how critical the Malacca Straits and the Persian Gulf are because Japan's dependence on oil imports. One of the best ways to make those areas more secure in a military sense, less threatening in a military sense, is for the United States to reduce its energy consumption. And I would consider any means including oil import fees, anything possible to reduce energy consumption in this country.

Clearly we have to address domestic competitiveness, and as part of this let me throw out another point to see what other kinds of boxing matches we can get going here. We need to establish as a matter of national interest this policy of domestic recovery and in doing so, we need to look at our technological base in a slightly different manner. If legislation is necessary to do it, then I would probably say three cheers—I'm overstating the case here—but I'd probably say three cheers to legislation that would make it illegal for an American company to sell or license technology for cash. I would use technology as leverage to regain reciprocal access to Japanese technology. In some cases, I would even propose very, very extreme measures that would include requirements in the cases of new technologies that any products—Japanese products—sold in the United States would be the result of a joint manufacturing venture in the United States in which the U.S. partner has 51 percent ownership. In such cases, an additional requirement would be licensing the Japanese technology to the American partner. I would start with high-density television technology. The reason is because there is very great potential in this particular area that trade in a few years in high density television products will absolutely dwarf

automotive trade and the balance-surprise is going to be overwhelmingly in favor of Japan. The United States economically, politically, and militarily cannot afford that. In critical areas we have to admit that, O.K., we goofed. We fouled up. We don't have the technology, but we can't afford not to have it. We cannot afford totally laissez-faire policies in this area because if we do, we're both going down the tubes. So on that optimistic note, I will turn it over.

Mr. NIKSCH. Thank you very much, Michael. Your prepared statement will be inserted in the record.

[The prepared statement follows:]

PREPARED STATEMENT OF MICHAEL W. CHINWORTH, PROGRAM ASSOCIATE, MIT-JAPAN PROGRAM ON SCIENCE AND TECHNOLOGY, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

SECURITY ISSUES IN THE EAST ASIAN CHALLENGE: AMERICAN POLICYMAKING CONSIDERATIONS

I. American policymakers generally consider the growing Soviet Military presence as the principal security threat to American interests in East Asia. The Soviet build-up has been a consistent buildup despite diplomatic overtures to countries in the region.

II. Japan is and will remain the most important nation to the United States in Asia. However, a complete identity of interests does not exist between the two countries in terms of defense and security issues. The United States is defending its interests against an encroaching Soviet military presence; Japan is making itself secure by assuring access to overseas markets, etc.

III. Defense is a subcomponent of security in Japanese policymaking. Furthermore, because of a number of reasons, including bureaucratic interests and the nature of the defense relationship with the United States, economic linkages to defense and security are strong. It is not an overstatement to suggest that Japan defines its security in terms of its economy. This economic bias can be seen in the nature of the defense/security policymaking structure in Japan in which several ministries and interest groups play important roles.

IV. Thus, the United States must be cautious in the development of its security relationships and policies in East Asia because they inevitably will involve trade offs of an economic nature for the country. Furthermore, the dynamism of the economic, political and security relationships in the region will necessitate constant appraisal of those policies to assure that alliances remain strong.

V. Expanded Japanese aid might not be in the best interests of this country because of the high potential for loss of markets in the region to Japanese corporate interests. Rather, a continuation and expansion of present defense policies—with an emphasis on justifying them in the context of the bilateral security treaty and international organizations such as the United Nations—should be the thrust of future policies. Aid should be encouraged, but carefully monitored and implemented in cooperation with the United States to assure a genuine strategic impact.

VI. The United States must not articulate and pursue policies in terms of expanded Japanese responsibilities in the face of reduced American capabilities. Expanded aid and defense spending by Japan must be encouraged in the context of consistent and growing policy role by the United States in East Asia. Otherwise, the moral authority of the U.S. over Japan—and hence its ability to pursue its interests in the Pacific—will be weakened.

VII. Domestic economic revival is an essential element of this strategy.

VIII. These relationships are not static. Japan does not seek preservation of the alliance out of a sense of commitment to shared values. It is up to the United States to preserve the relationship by asserting its leadership as the principal power in the region.

I. Introduction

Although some commentators have resorted to exaggerated prose in describing the economic and political transformations taking place in the Asian and Pacific region, it nevertheless is clear that changes are occurring that we in the United States only now are beginning to appreciate in terms of their impact on this country and its global leadership. The shifts in the region will have continued implications in the security area, but not necessarily in ways that policymakers here fully appreciate.

I would like to discuss some of the strategic challenges present to the United States by these developments and the implications of policy options in response to those challenges. The focus here will be primarily on Japan, for several reasons. First, it will remain the United States' number one overseas trade partner for the foreseeable future with other forms of political and economic interdependence increasing.

Second, while disputes between the two countries exist and will persist in some cases for years to come, Japan's political outlook is most compatible among East Asian nations to those of the United States. There are some important differences in its world view but it is fair to suggest that both countries are comfortable with their brands of democracy and seek to preserve those systems. The similarities in political objectives are numerous and differences are manageable if leaders in both countries exercise skillful diplomacy.

The third reason for focusing on Japan is that its postwar military buildup has occurred within the context of the U.S. relationship. There are innumerable debates about the precise historical role of the United States but there can be no argument that it has played a prominent role in Japan's postwar defense policies. This situation could continue but there also have been signs of increasing independence in Japanese defense planning that would suggest a more independent posture in the future.

Finally, of all the countries involved in the current burdensharing/military build-up debate, few occupy a more controversial position than Japan and few have greater significance in the future because of their combination of economic strength and political influence. This is not to underestimate the potential importance of countries to the United States, but Japan has declared itself to be a member of the West and remains important to this country's future because of that stance.

The point I hope to make today is that while the United States and Japan share many common perceptions and objectives, there also exist several importance differences that imply distinct policy tradeoffs. It is essential that the United States recognize those implications to maximize the possible benefits of the relationship.

At the outset, it is important to recognize that many of the thoughts here are broad generalizations. Exceptions always exist to these generalizations and they often are true of other countries as well. However, they do have particular significance to the U.S. Japan bilateral relationship.

II. Security Issues in East Asian: U.S. Conventional Wisdom

Let us begin by addressing the security situation in Asia. From the American perspective, the most important security issue in Asia is the growth of Soviet power, particularly of the Soviet navy in the Pacific. The Soviet Pacific fleet is the largest of the U.S.S.R.'s three fleets and increasingly is its most up-to-date. About one-half of the fleet is nuclear powered, for example. Nearly 80 percent of the fleet consists of missile cruisers/destroyers and aircraft carriers, with the remainder consisting of conventional destroyers and cruisers. Those percentages are the reverse of those only 15 years ago.

Soviet combat aircraft in the region number 2,390—about 25% of the U.S.S.R.'s total combat aircraft—and in the case of fighter aircraft—consist primarily of advanced generations. Bases at Cam Ranh Bay enable the Soviet military to project power as far as the Indian Ocean and the searoutes through which much of Japan's oil imports pass.

The Soviets have demonstrated their military capabilities to other nations in the region presumably with the intention of securing economic and political gains. For instance, Japan annually observes hundreds of flights by Soviet aircraft near and/or within its airspace. (The Japan Self-Defense Forces recently demonstrated its own resolve in this regard by firing warning shots at a Soviet bomber intruding in its air space last December, the first time an SDF aircraft has done so).

The Soviet military "stick" has been coupled with diplomatic "carrots." Mikhail Gorbachev's Vladivostok speech of July 1985 has been noted by many observers as an attempt to forge closer ties with Asian and Pacific nations. The Soviets have pursued closer ties with North Korea and in areas far more distant as well, including the Pacific island states of Kiribati and Vanuatu.

The objectives of these ventures are clear in some cases yet still difficult to ascertain in others. Without doubt, the Soviet navy seeks unrestricted access to Asia and the Pacific while strengthening its coastal defense against perceived threats. Some initiatives clearly are aimed at offsetting what the Soviet Union perceives as closer ties among the United States, Japan and the Peoples' Republic of China. Whatever the aims, it is prudent to assume that these trends have at least mixed implications

for the United States and its Asian allies until such a time as the Soviets demonstrate to regional powers less than hostile intentions.

This might require considerable time considering the legacy of actions that countries in the regions have seen as overtly hostile actions, including the invasion of Afghanistan and the destruction of the Korean Air Line flight 007. The United States, perceiving a threat in these Soviet activities, feels that it must defend the integrity of our allies in Asia from invasion an/or political coercion. Furthermore, our economic stake in the region has grown because of Asian development. By securing the military cooperation of our allies in the region, the immediate threat to the ability of the United States to pursue its own interests in the region—trade and investment—is lessened.

The underlying thrust of U.S. security policy in East Asia is that Soviet military increases must be matched qualitatively. A one-for-one quantitative increase is out of the question. Budget resources are not sufficient to match the Soviets in that manner. A dramatic increase could accelerate tensions in the region rather than reduce them. U.S. allies fearing involvement in a potential arms race could be scared away from their ties with this country through such programs. Furthermore, many would argue that quantitative increases are unnecessary since U.S. equipment and personnel are superior to the Soviets'. Finally, the willingness to project a deterrent capability might be as important as the actual force levels themselves.

Nevertheless, the problem is that is generally assumed in the United States and many other capitals that U.S. resources are becoming increasingly scarce, thus limiting our ability to carry burdens in the Pacific singlehandedly. Hence the calls in this country for increased defense and security related expenditures among U.S. allies.

I would characterize these positions as the conventional American perception of the security picture in East Asia. The threat is the Soviet Union and the appropriate response is a military buildup coupled with closer economic and political ties offset the growing Soviet menace. This policy response will make Asia more security for the United States and other nations in the region to pursue their economic and political interests peacefully.

A key element of this strategy is that it delineates the economic, political and military components from one another. Issues tend to be viewed in isolation or in the context of this country's overall relations with East Asian nations. Since it is important to the United States to neutralize Soviet gains by demonstrating allied solidarity, allowing issues from these three fields to overlap is undesirable from a policy viewpoint. In the case of U.S.-Japan relations, for example, both countries frequently warn of the dangers of trade issues spilling over into the defense arena.

Although the degree of the Soviet threat in Asia might be debatable, the course the United States has taken thus far concerning East Asian security issues seems to have been a prudent one. However, not all nations—particularly Japan—share this concept of security. While there is growing concern in Tokyo and other capitals about the Soviet threat, other elements play at least an equally important role in individual nations' strategies to achieve security. Furthermore, the policies the United States pursues to achieve its defense aims might unwittingly assist these contrary approaches to security, ultimately undermining other American interest in the region. Typically, what the United States views primarily as a military/defense problem has significant economic ramifications.

III. Security Policies in Japan

To understand this as applied to Japan, it is best to examine the nature of the security policymaking structure. Defense policies are formed by committee in Japan; they are not strictly the domain of one agency. While the Department of Defense does not have total control over the formulation of America security and defense policies, it is nevertheless safe to suggest that DOD is a lead player—if not the lead player—in articulating the nature of, and appropriate response to security threats facing the United States and its allies.

Such is not the case in Japan. The Japan Defense Agency has a secondary place in the overall bureaucracy. It is not a major cabinet position, but rather a secondary state agency. Seconded officials from the Foreign Affairs, Finance and International Trade and Industry ministries are involved in key decisions in such critical areas as policy planning and procurement.

More important is that "defense" is only a part of "security" policy formulation in Japan. While JDA on paper might be the lead agency in drafting defense policies, those policies are only part of a broader security policy structure for which the Ministry of Foreign Affairs takes primary responsibility in drafting and implementing.

Thus, JDA/defense policies are subjugated to MOFA/security policies in the bureaucracy.

Given the differences in bureaucratic roles among various agencies and ministries, it is understandable that Japan's overall approach to security would also differ from that of the United States. What are those interests and perceptions and their relative importance to the totality of the security policymaking structure?

The Japan Defense Agency.—As noted above, JDA is not always the most important player in the defense area, much less broader security concepts. Given JDA's status as a junior partner in its own domain, the most important bureaucratic priority is to establish itself vis-a-vis the more powerful ministries that are involved in defense policy formation. JDA's position in the bureaucracy forces it to view policies in terms of how they will affect its prestige as an agency and its bargaining power relative to the bureaucracy. This is particularly true among uniformed services in JDA which, because of Japan's historical experiences, obviously face residual suspicion among both policymakers and voters.

Having said that, it is still safe to say that the JDA views the Soviet threat seriously. Nevertheless, procurement and deployment decisions have not always suggested a sense of urgency on the part of the agency vis-a-vis that threat. The current view seems to be that the Soviet Union will not threaten Japan militarily within the coming ten years. Policymakers appear to believe that within that decade, simply the consistency of the present buildup—coupled with the potential threat of a rapid expansion of the military—will be sufficient to stave off any potential aggression by the Soviet Union.

Ministry of Foreign Affairs.—In the broadest context, MOFA is the most important spokesman for security policy in Japan, although its influence on the actual course of security policies must be shared with other ministries, particularly MITI. MOFA has the broadest, most international definition of security. It involves "pure" defense issues—suitable defense spending levels for Japan, the nature of the Soviet threat; appropriate procurement for SDF; etc.—and includes such issues as the role of Japanese aid programs in enhancing regional/global security.

Despite the willingness to identify the Soviet Union as the principal security threat in Japan, there are differences in the nature and appropriate response to that threat. Furthermore, some MOFA officials speak of the "Soviet threat" with U.S. relations in mind. The implication is that Japan gains favors with the United States—and thus experiences less pressure in other policy areas—as a result of its support of the American perception of the Soviet threat. This demonstrates again the primacy of the United States in MOFA's overall policy priorities. Paying homage to the Soviet threat is the price that must be paid to maintain a broader, more important aspect of Japanese security: the economic relationship with the United States. It is possible to view other aspects of Japan-U.S. security relations in this respect as well. The 1983 technology transfer notes, for example, was in part a means for the Japanese government to "score points" with the United States and reduce immediate pressures on the economic front.

Ministry of International Trade and Industry.—Although MITI is a commercial/industrial ministry, it is important player in the defense/security policymaking framework. Furthermore, it is likely that MITI's role will strengthen over the coming years because of three factors: 1) the security-economic linkage evident in Japanese policymaking; 2) the renewed importance of MITI in the overall policymaking structure in Japan; and 3) the growing importance of dual-use technologies to overall defense production.

As noted above, MITI officials play important roles in JDA's policymaking structure. The ministry has other means of influencing defense policy decisions, primarily through the various industry and sector offices within its halls and through such areas as export control.

Ministry of Finance.—The Ministry of Finance has been a critical player in defense and security decisions throughout the postwar period, particularly as the policy of "minimum necessary defense" became articulated. The policy outlined in the early 1950s by then prime ministers Yoshida and Hatoyama essentially was one that consciously restricted defense expenditures for a variety of reasons, including the need to rebuild the domestic economy, suspicion of militaristic revivals after the war and the protective presence of U.S. forces in Asia.

These policies are now an article of faith at MOF, where any spending on defense is viewed as a drag on the domestic economy. The broader notion of "security" to MOF means fiscal soundness: without a stable and fiscally sound government, it would be impossible to have any domestic economy at all, much less a defense establishment. Therefore, fiscal responsibility and restraint are the most important factors in the overall security picture to MOF. Thus, further spending on defense must

be defended in terms of its positive impact on the domestic economy. This is true to some degree in any country, of course, but especially important given the government's tight budgets and other economic/political factors we have discussed.

This helps explain why it is relatively easy for MOF to increase aid to a greater degree than general defense spending, particularly certain kinds of defense allocations. Stated crudely, aid is a money maker. Although Japanese aid increasingly is united in policy, in practice it remains heavily tied and advantageous to Japanese private sector interests. Aid programs are administered to a significant degree on a "request" basis: recipient governments must request funds for specific projects within their countries. Japanese corporations frequently assist local governments in developing projects.

Liberal Democratic Party "Zoku".—Political support for defense in Japan is something of a mixed bag. While there is political and obviously industrial support for certain acquisitions because of their positive patronage aspects, the body of articulate spokesmen for defense policy issues is somewhat mixed. The number of informed defense specialists in the Diet is growing, but it is still small and politically weak. Furthermore, it has been criticized as being something of a rubber stamp at present, with senior Diet figures justifying policies already developed by others.

Leaders of the defense zoku—the policymaking group within the party—tend to come from the ranks of retired JDA directors general with a minimum of eight terms in office. Instead of being individuals who are on the rise and make their reputations through the zoku, they often are instead politicians nearing the needs of their careers. The concentration of senior Diet members might help defense interests, but many of these individuals have not had the requisite experience in other, more influential zoku to give them the clout necessary to direct policy debates in the Diet and within the very important Policy Affairs Research Committee of the LDP.

For a variety of reasons, defense per se is not an area in which politicians can secure constituent support and, therefore, reelection. Ambitious politicians cannot make a career by being identified with defense policy issues as such because of lingering sentiments against defense among voters. Those who attempt to use defense issues as a vehicle for advancing their careers often find themselves facing premature retirement. This, I would argue, stands in contrast with the United States where leaders such as Sam Nunn, the late Henry Jackson and other have gained stature their informed positions on defense issues. Indeed, in the current political climate in the United States, it appears to be a prerequisite of national candidates to be "strong on defense."

Domestic industry.—Domestic industries, especially the larger firms such as Mitsubishi Heavy Industries, are looking to defense for future growth. Again, this does not vary dramatically from experiences in other countries, but it does have certain political implications given Japan's recent historical experiences.

It has often been said that Japanese corporations will shy away from defense business—particularly arms exports—because of the negative connotations associated with such business. Japanese companies indeed will be prudent with regard to expanding their weapons productions and exports, but I find no reason to suggest that these companies will not follow the pattern that they have demonstrated in other industrial sectors of trying to saturate domestic demand and then looking abroad for new markets. Japanese companies might not like the label "gun merchants," but it is not because of corporate pacifism or other ideological reasons. Instead, it is because they fear the possible loss of commercial and consumer business by suffering negative public relations impact from expanded defense sales. Several companies have indicated their willingness to take this risk, however, and the FSX experience indicates that the influence of the domestic industry is not insignificant in this regard.

IV. Economic Security

These interests indicate a very strong economic bias, suggesting that to the Japanese government, security is equated largely with economic survival and the vitality of its domestic economic base. The concept of economic security is nothing new. Alexander Hamilton articulated the philosophy of maintaining a strong domestic and internationally competitive economy in order to assure the security of the United States. The Marshall Plan and international aid programs in general have operated under the assumption that a strong economy minimizes the likelihood of political disruptions, internal disorder and outside invasion threats. In one sense, the United States is returning to its economic security roots, as evidenced by increased DOD attention to the interrelation of defense and the domestic industrial production

base. Ronald Reagan himself campaigned on this theme, speaking of the primacy of the domestic economy in his overall defense strategy in Chicago, March 1980.

Japan's institutional inclinations favor primacy of what the United States would consider economic factors in its security and general foreign policies, raising new issues about the country's appropriate defense role within the Western alliance. Much of the current debate about Japan's role in the world indicates a perception on the part of Japan's allies that the country has not assumed an international leadership role commensurate with its economic stature. Nevertheless, its role remains limited and directed toward a Japanese notion of its own economic security first and international priorities second.

This has developed for several reasons.

First is the understandable reluctance to project diplomatic initiatives after the experience of the war. This is particularly true of the postwar economic recovery period. Some recent initiatives have backfired.

Second is the existence of somewhat unusual security arrangements in which the United States has emerged as Japan's military protector. This has allowed, and perhaps even encouraged, Japan to focus essentially on economic security instead of the more conventional concepts of enhancing one's security—that is, rearmament.

While Japanese diplomacy is becoming more adept, the economic thrust of its policies will remain unchanged unless the security treaty with the United States is modified significantly or abandoned altogether. Because of the political implications and potential drawbacks to the United States of such steps, however, serious treaty negotiations are unlikely to take place in the near future, leaving the United States in a situation where its most important ally in Asia views security issues in a considerably different light from Washington.

Tokyo has recognized this situation and opinionmakers are examining broad roles and missions for the parties in this relationship, with Japan fulfilling the economic demands. For example, both private sector and government figures are recasting Japanese investments overseas in terms of their contributions to global security. Another possibility is that Japan will propose a division of labor theory in which the United States essentially acts as Asia's protector while Japan provides economic security for the region.

These concepts are not necessarily in the best interests of the United States. The idea of a division of labor in particular is totally undesirable since it could easily result in the loss of important market opportunities for American businesses in Southeast Asia.

Similar pitfalls exist in proposals for expanded Japanese aid. In the course of the ongoing burdensharing debate, considerable emphasis has been placed on Japan spending more on "strategic aid" as a means of contributing to global security. This has been promoted among those who respect domestic constraints on defense spending (political sensitivities toward the military; constitutional considerations; etc.) and those who fear further growth of the Japanese military establishment. Figures mentioned have been as much as 3 percent of Japan's GNP.

The United States should view those proposals cautiously. As mentioned earlier, Japan's aid program has been severely criticized for promoting Japanese exports to key markets, especially Southeast Asia. Japan is willing to spend more on aid because it achieves its own economic security objectives, solidifies political/security relations with its allies (primarily the United States) and reduced domestic and international pressure to spend more on defense.

The price that we might have to pay for this—literally—could be a heavy one. Already it is a very difficult for American companies to penetrate or expand their markets in Southeast Asia because of a very strong Japanese presence. Additional Japanese aid to those countries is likely to strengthen the hold on those markets. Policymakers in this country must therefore ask if sacrificing these potential export markets is the price this country is willing to pay in order to secure greater Japanese burdensharing contributions. It indeed raises the question of whether it is a "burden" to share if the results are expanded Japanese export and investment opportunities.

There are additional reasons for not being too hasty in embracing Japanese aid proposals. The first is the need for administrative reform. Even at current levels, Japan's aid programs are overwhelmed. There is an estimated \$6.3 billion backlog in aid allocations. Multiple jurisdictions retard efficient allocations and the staff to implement existing programs is overburdened. Thus, there are administrative questions regarding the ability to Japan to spend that volume of funds.

In cases where Japan has allocated special funds to strategically important countries the record is not all that clear as to whether the funds were sufficient to make a significant impact on regional security. More than a single block allotment for one

or two years will be necessary to make impact in a countries such as Turkey, Pakistan and Afghanistan, but overall aid patterns have remained largely unchanged over the years with Southeast Asian nations the favored recipients. Furthermore, there are indications that Tokyo has no intention of altering aid distribution for the foreseeable future.

There is another potential role for Japanese strategic aid but it would be very controversial in Japan and perhaps in Washington as well. The proposal for consideration is this: for Japan to allocate funds for security assistance to be used by recipients for enhancing their military capabilities in an appropriate manner. Funds could be used for acquisition of particular systems from Western allies or for non-lethal purposes such as communications and training. In one respect, the precedent for such a program has been established with Japan's contribution of navigational systems for Persian Gulf ship traffic.

V. Regional Issues and Considerations

There are a number of other regional issues involving these considerations that are worth noting for a moment. It has been noted, for example, that there remains considerable suspicion among many Asian countries towards Japan's defense build-up. For example, recent discussions in Japan of acquiring aircraft carriers for the Maritime Self-Defense Forces seems to have caused considerable concern even in the United States. This raises further difficulties for the United States of dealing with frictions among East Asian allies while promoting efforts to offset the Soviet challenge. Looking at two other military principals in the area illustrates those and other difficulties. The following list is far from exhaustive, it is offered here as a point from which to begin discussions.

The Republic of Korea is one of the most important countries to Japan in terms of its own security. The country lies at the closest point to Japanese territory and a war has been fought there in recent memory. Furthermore, there is no reason to assume that continued instability would not produce another conflict in the future. Japan views the U.S. commitment in South Korea with some caution, since it has seen moments of unreliability in the past such as the 1976 pledge of then presidential candidate Jimmy Carter to withdraw American forces from the country.

The economic growth among Asian countries brings long term considerations to American planning since it contributes to their potential for independent military capabilities. South Korea already has a sizable military presence, for example. A serious question exists over the implications for regional stability of this growth if it is coupled with an increasingly powerful military power projection capability. This is true even among nations that currently are considered American allies.

U.S. press reports suggest that South Korea views the United States with increasing hostility. The combination of a booming domestic economy and growing military capabilities would suggest that the country could exercise more independence in its security policies from the United States. At what point, if any, would this become an inherent source of instability in the region?

Other issues exist that are of critical importance to the United States. Again examining experiences in South Korea, there has been evidence of the ROK's failure to adhere to at least the spirit of bilateral security agreements. A recent report by the General Accounting Office, for example, indicated that the South Korean government produced far more M-16 rifles than permitted under the bilateral memorandum of understanding, apparently with the intention of re-exporting them to third countries. This type of problem mirrors private sector concerns in such areas as intellectual property right protections and raises the issue of when an ally becomes an adversary. Could continued support for any South Korean regime become detrimental to other American interests?

Relations with the People's Republic of China illustrate other challenges. Important in economic terms, it is possibly Japan's most important market in the next century. Japan must be sensitive to Chinese policy concerns because of this. For its own part, the PRC has been very effective in satisfying many of its economic and political goals with Japan as illustrated by Japanese willingness to harmonize its CoCom regulations to reduce trade disruptions with the country in important, high-tech areas. The combination of these conflicting pressures could force Japan at some point to make choices between the United States and the PRC, perhaps to the point that it could drive a wedge into the U.S.-Japan relationship.

VI. Policy Options: Military and Security Considerations

The United States thus faces a difficult challenge in Asia, namely, achieving this country's objectives in cooperation with its allies while reconciling those interests with their often opposing view of enhancing security. A combination of factors presents the United States with several difficult—perhaps irreconcilable—choices in-

volving several economic, military and political variables. Any of these options will have distinct tradeoffs involving these military and economic issues. These options involve aid, appropriate levels of defense spending by allies, and various forms of indirect assistance to U.S. forces.

The first step is recognizing the inescapable reality that these policy options will involve certain economic tradeoffs. For example, attempting to secure Japanese contributions into new codeveloped weapons systems might be a desirable policy option for the United States but it will also mean elevating the capabilities of the Japanese defense industry and potential competition for the U.S. in the future (a far from comprehensive list of policy options and their implications can be found in Table 1.) The key is to minimize these potential economic drawbacks while maximizing U.S. security concerns in East Asia.

The United States must consider approaches that emphasize policy coordination, indirect means to support the U.S. in Asia and perhaps review in very broad terms of the philosophy underlying the U.S.-Japan security treaty—but not necessarily the agreement itself. The objective is to strengthen the U.S.-Japan tie, recognizing that neither a fully independent Japanese military force nor some of the economic tradeoffs necessary in other options are in the best interests of this country. A major goal of American policies must be to commit Japan to the U.S. perception of security in the Pacific, which distinguishes to a larger degree economic and military functions than the present Japanese policymaking mode.

Possible policy options—summarized in Table 2—would include the following:

- Continued emphasis on working level consultations, including the annual Hawaii defense subcommittee discussions. While those meetings might not be the most dramatic in the world, they have institutionalized bilateral cooperation and have become an avenue to broach new means of interaction.

- De facto multilateral exercises and planning through simultaneous sets of bilateral exercises and discussions with the United States again playing the central role. This would mean, for example, a series of U.S.-ROK and U.S.-Japan training exercises and/or study groups on anti-submarine defenses in common straits. The critical element is for the United States to remain the central initiator and player in these efforts to achieve multilateral cooperation while sidestepping political and legal obstacles to direct cooperation among many of the countries in the region.

- Special, long and medium cooperative studies such as the sealane defense plan. Recently initiated talks on antisubmarine warfare could fall into this category. It would be useful for the United States to initiate discussions with Japan on the inter-relationship of domestic economy/industrial base and national/international security. Other possible topics would include more active discussions of conventional force utilization in nuclear scenarios; international arms control issues; intelligence monitoring.

- High level policy emphasis to assure the success of technology transfer notes and other means of contributing to the U.S. industrial base. Clarifying the U.S. position toward foreign, and specifically Japanese, investment in national security companies would be an important step in reducing frictions and furthering cooperation in this area.

- Continued, moderate defense spending by Japan, but especially on sustainability items, support for U.S. bases, bases defenses, etc. However, the expanding the present roles and missions of the Japan Self-Defense Forces should be examined with care and caution for several reasons. First, the SDF has more than enough at present to keep its hand full with sealane and coastal defense. Second, expanding the current roles could mean institution of such policies as sealane defense to the north of Japan, again by as much as 1,000 nautical miles. While this is a logical extension of present policies and has support in many Japanese circles, it would entail still further front line, "big ticket" procurements that would have significant regional and domestic implications.

- Japan can and should spend more on defense without damaging the domestic economy. But the concern should focus on achieving defense goals most efficiently. In that context, the recent carrier debate might be more important in terms of whether the proposals originate in the private sector—which would be interested in the positive production and employment impact of such programs—or among planners concerned with the most effective means of enhancing antisubmarine warfare capabilities.

- Level headed recognition of the economic aspects of U.S.-Japan cooperation. There will continue to be disagreements between the two countries on the degree of Japanese domestic development and production of new, advanced weapons systems. To deal with these inevitable conflicts the U.S. must decide the extent and nature of Japanese participation in the development of future systems and what specific

prices the Japanese are expected to pay for participating in these programs. The U.S. will have to accept the tradeoffs between development of the Japanese aerospace industry and participation in codevelopment projects. The only alternative would be steadfast refusal to cooperate with Japan in any form, but this clearly will not achieve U.S. economic, political or military objectives.

- Additional aid in conjunction with expanded aid by the U.S. and with joint planning. Only by increasing its own role can the United States expect to have any influence on Japanese decisions. Japan's steps must not be viewed in terms of filling an American void, which, unfortunately, they are today in practice. The U.S. must assert leadership as well, not simply exhort Japan to do more.

- Clearly establishing the rationale for policies within the context of Japan's inter-national and bilateral security agreements. One of the keys is to facilitate further Japanese contributions in the overall framework of the U.S. mutual security treaty and, to a lesser extent, the United Nations charter. For example, the recent decision by Prime Minister Takeshita to allow limited Japanese participation in UN peacekeeping forces seemed to have brought little negative reaction in Japan, largely because the decision was made in terms of Japanese contributions to an international organization with considerable legitimacy in the eyes of the Japanese electorate and decisionmakers.

- Furthermore, this would help alleviate regional concerns over the direction of Japan's defense policies. Although I would argue that Japan is not likely to return to 1930s-style militarism, this is nevertheless a policy consideration that must be addressed by the United States as the principal security power in the region.

- The most effective means of addressing these concerns is by assuring that the Japanese military expansion take place within strictly defined bilateral arrangements, including the Mutual Security Treaty. Some players in the region might still protest any additional spending hikes by the Japanese government, but in private they would be more willing to accept them as long as they took place with the clear understanding that the United States would continue playing the key role. My added suspicion is that some nations protest Japanese military spending levels in part with the aim of achieving diplomatic gains in other areas.

- This policy direction also means diplomatic reciprocity. This is an area in which the two countries have made tremendous strides. Briefings on a broad range of issues are now a routine aspect of U.S.-Japan relations. There might be exceptions to this practice, but for the most part we seem to be relatively free of the possibility of new "Nixon shocks." Hopefully, this practice will continue and will be expanded on both sides to include still more economic, political and security issues of common concern.

VII. Domestic Economic Recovery

It is also important for the United States to focus on more than simply higher defense spending. Perhaps the most important issues relate to our domestic economy. These include:

- Reducing government deficits through institution of oil imports fees, value added taxes and/or other consumption taxes. Means of improving saving rates must also be addressed. Finally, control over existing entitlement programs must be established. Although it is fraught with dangers, alternative means of structuring Social Security programs could also be part in this package. In terms of the immediate security impact, however, the oil import fee, coupled with other measures to improve energy efficiency and reduce consumption in this country are perhaps the most important.

- Linking trade policy with domestic competitiveness: Couple any import relief with export/domestic market competitiveness plans by companies, including ban on non-sector acquisitions during relief periods. Establish as a matter of national policy the refusal to sell technology for cash, using technology holdings instead to gain reciprocal access, especially in defense.

- Establish as a matter of policy the national interest of domestic recovery. Confess that the United States has not attended to its affairs as well as it could have, but also indicate to our allies that certain steps must be taken in order to preserve the domestic economic base and, therefore, our ability to defend the free world. This policy would include the necessity of Japanese corporations licensing new technologies to joint ventures with American partners in order to produce and sell new products in this market.

VII. Relationships in Transition

Many of the points raised in this discussion may have had somewhat negative overtones, but it is not my intention to suggest negative motivations on the part of either Japanese industry or the Japanese government in its foreign and economic

policies in Asia. Instead, it is my hope that U.S. opinionmakers will realize that significant differences exist that lie rooted in pragmatic and rational outlooks on the region based on a variety of reasons.

It is important to remember that the East Asian region is a dynamic one and thus the relationships among the countries in that region will face continued challenges over the decades. Japan, for example, certainly does not necessarily view the current security situation as permanent one. The country has allied itself with other major powers in the past to achieve certain security, economic and political goals. If the United States loses its ability to garner political prestige for Japan or to assure its physical security, it is not totally infeasible that the country would consider options for supplementary or replacement relations with other states to fill that gap. Another alternative is that Japan will reach a stage that it feels confident to embark on a totally independent foreign policy course, heightening the adversarial aspects of the relationship while diluting its cooperative elements.

Japan does not look upon its relationship with the United States as something that inherently is desirable for its own sake or as one that should be maintained out of sense of philosophical commitment to shared ideals. Much has been written about the growing arrogance of Japan toward the U.S., with the implication that Japan no longer needs this country in a political or economic sense. Assuming that this is true—and that is a debatable assumption—it could lead to undermine the bilateral relationship and U.S. economic/political influence.

There are a number of trends and transformations in East Asia that could also affect American security interests in the region in a similar manner. Although it involves elements of speculation, they could include the following scenarios:

- The United States could continue to grow weaker economically, forcing Japan to turn to other countries to provide new markets, technology and investment opportunities. Indeed, some Japanese industrialists might already view the U.S. as a fading economic giant, thus necessitating such a search.

- China could emerge as Japan's major economic partner and/or most promising market, precipitating some of the problems mentioned above for the relationship between the United States and Japan.

- Growing Soviet power could force Japan to reexamine its policies on rearmament, moderating Soviet behavior through economic policies and reliance on the United States as its principal military protector in the region.

- The return of Hong Kong and a Taiwan-mainland reconciliation could profoundly affect security issues in the region.

The important point in most if not all of these cases is the assumption of a declining U.S. presence and influence in the Pacific and the critical role of Japan in the American future in Asia. The United States must therefore project an image of strength vis-a-vis Japan in order to sustain the political leverage necessary to convince its ally to cooperate. If Japan perceives an American decline—and many policymakers already see that happening—it will be extremely difficult to secure Japanese cooperation. Relations could then grow more acrimonious.

To project this image of strength, the U.S. must not "get tough" on Japan. Quite the contrary. The United States must demonstrate to its allies that it is committed to its own future in Asia in conjunction with other democratic and capitalistic powers in the region. It must demonstrate that it is committed to the notion of remaining the number one superpower of the democratic world—the linchpin of the Western alliance.

TABLE 1: U.S.-JAPAN POLICY CONSIDERATIONS IN ASIAN SECURITY

Policy Option	Assumptions/ Motivation	Tradeoffs Implications	Comments
Japan should			
.Increase aid to as much as 3%	. P o l i c y constraints/ fear of militarism	.Loss of market access in SE Asia	.Acceptable price for restraining military?
.Work with U.S. on Asian "division of labor"	.U.S. and Japan are the leading powers in Asia	.U.S. role military; Japan's role economic	.Frightening prospect to Asian nations; severe U.S. economic sacrifices
.Freeze defense spending at current levels	.Japan has done enough and/or cannot spend more	.U.S. would have to spend more to offset Soviet power	.Resources limited; does not strengthen U.S.-Asian alliances
.Spend more on front line weapons systems	.Need for far greater military contribution	.Strong economic linkage/domestic industry benefits	.Issue: most efficient defense
.Promote technology transfer/codevelopment	.Can make contribution in its best interests yet observe peace constitution	.Strengthened civilian/military industry in Japan	.Industry view: cooperation # its best interests
.Spend more on "non-lethal defense"	.Political constraints on defense still strong in Japan	.Substantive contribution, but not politically visible	.typical target: base support; should not obscure other defense needs/issues
.Assume new missions (1,000 mile northern sealane defense)	.Logical extension of current roles and missions	.Implies nuclear sub force and/or aircraft carriers	.Likely to be politically unacceptable in U.S., Asia
.Defend U.S. in Asia under revised Security Treaty	.U.S. relationship has developed into genuine alliance	.Full partnership for Japan in Asian planning	.Popular opposition in Japan; policy opposition in DOD

TABLE 2: *Security Issues in the East Asian Challenge: American Policymaking Considerations*

Military/Security Considerations

- (1) Continued emphasis on continuous working level consultations.
- (2) De facto multilateral exercises and planning through simultaneous sets of bilateral exercises and discussions.
- (3) Special, long and medium cooperative studies such as the sealane/ASW defense plan.
- (4) high level policy emphasis to assure the success of technology transfers/codevelopment programs and Japanese contributions to the U.S. industrial base.
- (5) Clarifying the U.S. position toward foreign, and specifically Japanese, investment in national security companies.
- (6) Continued, moderate defense spending by Japan, but especially on sustainability items, support for U.S. bases defenses, etc.
- (7) Caution regarding defining broad new missions/roles for Self-Defense Forces.
- (8) Recognition of economic tradeoffs involved in security relations with Asia, Japan in particular.
- (9) Continued cooperation in aid programs, but no dramatic expansion for now by Japan. Maintenance of U.S. aid programs at least at their current levels is a policy must.
- (10) Key objective: retain central U.S. role. Japanese policies must be developed in terms of the U.S. security perception in Asia.
- (11) Reciprocal diplomacy with Japan.
- (12) Do not "get tough" on Japan.

Domestic Economic Policies

- (1) Addressing domestic fiscal problems.
- (2) Reduce oil/energy consumption.
- (3) Improve domestic competitiveness.
- (4) Establish as a matter of policy the national interest of domestic recovery.

Mr. NIKSCH. Now let's hear from Ellen Frost, who is currently Director for International Affairs, United Technologies. She was formerly with Westinghouse and as many of you know has worked at the Defense Department and on Capitol Hill. Ellen has developed a very strong expertise on Japanese defense policy issues as well as the defense and technology implications of the Japanese buildup.

Dr. Frost, please.

STATEMENT OF ELLEN FROST, DIRECTOR, INTERNATIONAL AFFAIRS, UNITED TECHNOLOGIES

Mrs. FROST. Thank you, Larry. I don't know whether you've talked about the calendar but it's only a few months before a 4-year tribal ritual in this country, known as the presidential election. I want to start my remarks with that because what follows is going to be perhaps more optimistic than either Michael or as I understand it, Ron have said.

It's my view that both presidential candidates wouldn't waste 5 minutes disagreeing with this premise—that we have to take economic issues more seriously as an element of our national security. And incidentally, it isn't just Japan and Asian countries which define security in economic terms. Our European allies have done this for a long time. Even the United States, I would argue, incorporated economic strength in its vision of security in the late 40s and 50s. We encouraged Germany to begin exporting even to Soviet markets in the early 50s on the grounds that this promoted recovery. We excused Japan from sharing the burden of the Korean War, again on the grounds that to do so would slow down Japan's

economic recovery. In both cases, we saw correctly that the economic strength of once defeated adversaries would strengthen our overall strategic position in the world. In this country, what happened was that we took our economic strength for granted and began identifying it with laissez-faire policies, instead of seeing that our economic preponderance stemmed from the peculiar circumstances of World War II. I think we're learning otherwise now, to the point where we no longer have to debate the general premise that security rests in large part on economic strength.

I would also be upbeat on a second theme, which is that I think it's hard to find real threats to the United States in Asia today. That may be jarring in view of the gloom and doom expressed in this room, but if you compare our position in Asia with what we faced 40 years ago, I think we're in relatively good shape today. There are dangers in the Philippines and in Korea which perhaps Tom will touch on, but I find, on the whole, the Soviet Union is unlikely to be an aggressive power in Asia. Like everyone else, I am watching for signs that Gorbachev really means to carry out a peace offensive in Asia that matches words with deeds, but nevertheless, I don't think that's going to get any worse, and even at current levels the Soviet presence seems to be bearable. Similarly, I don't see China as a fundamental threat to Western interests.

Nor do I see any danger from a rearmed Japan. Barring a resurgence of militarism which is unlikely, I don't see Japan as a fundamental threat even if Tokyo becomes more independent of Washington. It may be healthy to some extent to have the Japanese more independent and less captive of Washington. I even see a potential role for the Japanese in the world that is complementary to but not identical with ours. I'll touch on that a bit later.

So if things are as good as I say they are, maybe we should declare victory. Now I'm not saying we should declare victory and go home, because everybody wants us for their own reasons to stay in Asia in some way. I don't really mean "everybody," but at least major governments seem to want the U.S. presence to continue, if only to balance us against somebody else. For their own reasons, the Chinese want us. The Indonesians want us. Lots of people want us to remain in Asia. I don't think we could disengage even if we wanted to for a number of reasons, chief among which is that we are a Pacific power, whether we like it or not. So I don't believe that we should declare victory and go home.

I do believe that we should declare victory and try to redefine what our interests are. Here I think that we are running into a historical shift that is hard to define but it goes something like this: Because of the very success of the Pacific community, economic growth, economic interaction and technology transfer are transcending national borders. But we're still sitting here talking as if countries have a line around them that is somehow firm. What both we and Japan need to do is to define our national interests in ways that include not only national territory but the Pacific community more broadly. It's already clear that technology transfer, investment, capital flows, and other kinds of transnational transactions are dwarfing the flow of goods that move in ships between borders, namely, trade. And yet it is trade with its visibility, with its clear association with jobs, that is generating a lot of the heat

and emotion of U.S.-Asian relations. I think we have to put trade in perspective and not allow it to overshadow other interests. That's not to say that I disagree with Clyde Prestowitz or Ron or others. I do think trade is important. We have to pay our bills. We do need to manufacture and export. But I think that we have to define and measure our interests in Asia in a way that explicitly recognizes the significant victory that we have won over the last 40 years: a thriving Pacific community.

Since we've touched on technology, let me say a little bit about that. We need to define some new issues or rather to bring some latent issues into the light. Technology is a prime candidate. It's a major asset of Japan. For the U.S., it's also the key to tomorrow's trade and competitive strength, and it's a prime candidate in my view for pulling our own economic act together.

Yet technology isn't receiving the attention it deserves. I'm amazed, for example, that we are not intensely debating the commercialization of R&D. I'm talking about commercialization in a double sense—not only getting it out of the lab and into the marketplace, which is what is usually meant by the term, but also getting it out of the military domain into the commercial domain.

I'd like to give you some figures here. Roughly half of all the R&D in this country is paid for by the U.S. Government—half. In Japan and Europe it's in the order of 20 percent or so. So there's a huge amount of money going into R&D, but of that total, half to two-thirds—and it's more like two-thirds in the 80s—is defense-related. Now that category isn't limited to things that go bang. Put on a piece of paper a list of technologies that DoD is funding, and compare those with technologies that the Japanese have identified as key to the 21st century. Guess what? They're almost the same—fiber optics, gallium arsenide, next generation computers, new materials, composites, and so. Some things that are funded by the Pentagon are truly military or classified or lethal, but you can't tell me that all of that money that DoD spends for R&D is uniquely military.

I think we have to find a way of getting that technology released into commercial domains. One problem is that companies segregate themselves internally in a pattern that corresponds to this military/commercial bifurcation. They are often required to do so by the government—security regulations, no foreigners, et cetera. I think we have to take a very hard look at that.

With respect to Japan, I agree with Michael. I think technology transfer is a very fruitful field for Japanese activity. I share his skepticism about just pouring money around. There's a limit on the absorptive capacity of developing countries. There are problems of corruption. There are other obstacles as well. I'd like to see Japan propose some technology initiatives in fields where they're strong. I'd like to see them design a special program for aging, elderly people in Third World countries. I'd like to have them share their expertise on environmental problems and disaster relief. I'd like to see them in small-scale energy projects, doing more in that field, more on the technology sharing side than on the straight aid side. I even think there's a big opportunity for Japan to pursue political military initiatives in the world that are consistent with Japan's special concerns for peace. Verification, for example, is a natural

for Japan—arms control verification, the use of remote sensors, post-conflict monitoring, and reconstruction aid. The Iran-Iraq situation is a ripe plum for picking. I think Japan should propose a major reconstruction package for Iran and Iraq that would include the application of advanced technologies to monitor the peace. Mediation is a natural Japanese strength. We're too visible and too noisy to mediate. We like to jump on the table and make speeches. The Japanese are very good at *nemawashi*—consensus-building behind the scenes. They tried to do this in Iran-Iraq. The fact that they couldn't stop those people from killing each other is not a fault of Japan. Outside of Asia, particularly where Japan doesn't have all this historical baggage, I think there's a tremendous role for Japan.

It would help if Tokyo would take some real initiatives instead of waiting to be asked. I understand that last week there were U.S.-Japan discussions on co-development of weapons and that Japan took some initiatives, and proposed some things. I personally welcome this. I don't think it's threatening necessarily. I just think it's part of the transition process that we haven't psychologically adjusted to.

I will make one more comment, since I snorted a bit in response to Michael's notion that we should ban the sale of technology for cash. I think the first reaction from industry would be, "no more laws!" "Not one more restriction on how companies do business!" We are already grumbling about export controls, and about the Foreign Corrupt Practices Act, and on and on and on. Despite lip service to competitiveness, we still have foreign policy controls. I think one more export ban would send people through the roof.

On the other hand, there is something inappropriate in just engaging in the offset game with Japan or East Asian countries in the classic way. You know the standard question: what technologies do we have that can enhance our bid package? And I agree with Michael that there has to be an emphasis on two-way technology transfer as a condition of business. I agree that businessmen have to overcome their not-invented-here mentality, and look actively for technology in Japan in a way they're not doing now. So I share your general perspective, but please—no more laws at this particular point in time.

And finally, Michael, despite your very elegant analysis of some of the threats, I think you contrived a few. I'm not sure that I see China as a threat in the way you described it, I think I come out where you came out in your table 2 here. Table 2 contains a very sensible list of approaches to pursue. He ends with a plea "not to get tough on Japan." It is not inevitable to me that MITI will get stronger. I think it will only do so if we keep "bashing" Japan because pressure of that sort has the effect of keeping the government in the center of things. We have to be a good deal more subtle than we have been. I repeat my opening point, which is that in the next 4 years our relations with Asia are likely to become more harmonious rather than less.

Mr. NIKSCH. Thank you, Ellen. We'll turn now to Tom Robinson who is Director of the China Studies Program at the American Enterprise Institute and Adjunct Professor at Georgetown University. Many of us know Tom as a very prominent scholar and thinker on

East Asian security issues, who has been contributing his ideas and thoughts for a number of years on the Washington scene.

Tom please.

**STATEMENT OF THOMAS W. ROBINSON, DIRECTOR, CHINA
STUDIES PROGRAM, AMERICAN ENTERPRISE INSTITUTE**

Mr. ROBINSON. As a Sinologist and a part-time Sovietologist, I want you to know that I feel enormously inhibited in being brought into a room of Japanologists and asked to talk about Japan and East Asia. In fact, I'm not sure I can make a good contribution. I would like to talk around Michael's paper and proceed from Ellen's remarks in an attempt to broaden our view of East Asia. I will move away from a near-exclusive emphasis upon Japan and toward an assessment of the overall American approach to the region in terms of an amalgam of economic, national security and other factors.

Allow me first to enter a professorial remark on the term "national security." This term is a weasel word, as you well know. It's so broad and all-encompassing that it has essentially lost all meaning in a specific sense. This is thanks largely to attempts by various administrations, both Republican and Democrat, to get monies out of the Congress for whatever desires seem in vogue at the moment. By attaching a national security component to any claim, it becomes possible to justify all kinds of programs, departures, proposals, expenditures, and actions under the term "national security." Nonetheless I think it's good to speak in national security terms so long as we pull the term back apart, as we have to some extent this morning and this afternoon, and speak about its various components—be they economic, military, diplomatic, and other. This is particularly true if we can speak upon their various linkages, and that's what I presume this meeting today is in fact all about.

Having said that, let me enter a few remarks about what I perceive the national security situation in the region as a whole. First, I do not consider the Soviet Union to be the national security threat to Asia. I think that is a red herring Michael was saying that and I want to underline that. The Soviet Union has a very large Asian military force, but it cannot be used in Asia except as concerns World War III or in a direct attack upon China, both of which probabilities are vanishingly small. The Soviet Union now deemphasizes the military factor in its approach to Asia in favor of economic participation. The Soviet Union is both compromising, militarily with regard to China and withdrawing from Afghanistan and to some extent from Vietnam. These are important positions it has long held in Asia. The Soviet Union is essentially today internally-oriented during the period, however long or short it may be, of Gorbachev's *glasnost* and *perestroika*. Finally, a large percentage, probably at least one-half, of its non-ground Asian-based military force is actually devoted to the strategic nuclear deterrent equation with regard to the United States and is only accidentally, as it were, based in Asia. So: I would say if we are going to talk about security in Asia, we should not direct our attention primarily to the Soviet Union, as we have to some extent in the past.

Second, yes, Japanese-American relations are the principal aspect of the American policy approach to Asia today. It has been so in the past, and perhaps it should be that in the future. But the security threat, if there is one in Asia, (and I again agree with Ellen in that we may have to look for it), does not and probably will not come from problems in the American-Japanese economic relationship nor the security alliance between the two countries. So far as I can see, the problems between the two countries are both manageable, and if they are taken together or separately, not threatening to the overall relationship. Japan and America are mutually interdependent, and mutually dependent. I would like to separate those terms as they are different. We are interdependent and mutually dependent sufficiently enough it would seem very difficult for either or both sides to destroy this "special relationship" that has been created over these several decades.

Third, some people in the United States wisely caution against rocking the boat too hard vis-a-vis Japan. Even the presidential campaign now under way has shown that taking too hard a stand with Japan does not sell politically. After all, the Gephardt campaign did not go very far on the basis Japan bashing. In Japan, the whole polity and the culture stands against the idea of a serious separation from the United States. These developments and qualities are going to keep the Japanese and the Americans together through the thick and thin that we're going to face each in the near future.

The security threats in Asia in the broadest terms, therefore, do not come from the Soviet Union or from the Japanese-American problems. They come from three other areas. One is the middle-ranking communist states—North Korea and Viet Nam, more the former than the latter at present. The second, (and I disagree with Ellen here) is the impending expansionist tendencies of China. The last is the revolutions from below in societies that are left behind or are falling behind in Asia's rush to economic modernization: the Philippines, Indonesia, and increasingly Burma.

Having said that, there are a series of opportunities and dangers. Here I speak in Chinese categories (*wei*: danger; *ji*: opportunity; *wei-ji*: crisis), for the United States in facing the possibility of a crisis situation with regard to Asia: Let me look at opportunities first, and then dangers.

First of all, the opportunity may present itself to the United States after the Olympics, presuming the latter takes place peaceably, to advance the cause of settlement of the Korean problem. I think we are going to move fairly rapidly into a situation of all around cross-recognition. That could well set the stage for further movement toward a more enhanced security on the Korean peninsula. It is a duty as well as an opportunity for America to assist a post-Olympic diplomatic demarche.

Second, we have an opportunity to build a genuine trans-Pacific economic community. Not only the United States, Japan, and the NIC's, but also Australia, New Zealand, and the other free market nations of Southeast Asia will participate, with an offer to China and eventually, but not now (as the phrase goes), the Soviet Union.

Third, we have an opportunity to make a showcase of the Philippines, in terms of reform, development, and democracy. I think I

can obtain a nod of assent from Larry Niksch on that. It seems to me the Philippines situation is made to order for application of the kind of policy and resource investment that America does best.

Fourth, we have an opportunity to help Indonesia and Thailand enter the road of rapid economic development and broadening democratization. The opportunities there are enormous for the United States.

Fifth, we have an opportunity to wean Viet Nam from the Soviet Union, and to assist it to turn onto the road of a mixed economy and eventual political modernization and democratization, perhaps along the lines that China is now following.

Sixth, we have an opportunity and I would like to stress this to maximize our most important quality vis-a-vis Asia: management and leadership of, and in, the region by participating in the great task of building a trans-Pacific community. The United States has an absolute advantage, not a comparative advantage, in management and leadership, and that's where our task ought to be. Nobody else can do that task as well as we can.

Lastly, we have an opportunity to use rapid economic development as a device to avoid or to transform or to neutralize many of the present range of security threats to the region. Positively, we see quite clearly what rapid economic development has done with regard to transforming the security situation on the Korean peninsula, and the relationships between Taiwan and the Mainland China. Negatively, we can see the very same thing occurring with regard to the Philippines. We have a potential as I said to convert Thailand and Indonesia into showcases of economic development. Now, having said that, there are also dangers. Let me list some of these.

First, there is the long-term danger of a growing confrontation with China. China is a country with which we are going to get into a power contest, whether it be over Taiwan, or regard to trade, military sales, or other kinds of issues. This power contest will not merely modify the present set of ties and assumptions between our two countries, but push both of us, if we do not take care, into the ranks of mutual enemies. Neither of us wants that now, but we could well move in that direction, if both of us do not change.

Second, we are in the danger of pushing Japan so hard on trade and defense that the economic and military bond would be broken and Japan could go its own way. We have discussed before and I shall not elaborate.

Third and most important, the danger is that we not put the American domestic economic house in order so that the net applicable power, and, therefore, our leadership, in Asia will continue to slip. This is a *sin qua non* for successful maintenance of our position in Asia.

Fourth, we must avoid the temptation, of unilaterally withdrawing from Asia in the military sense. We do face some prospects or possibilities of that with regard to the Philippines and South Korea. And we should not avoid seizing the opportunity to fashion a loose America-centered security condominium in Asia. I am not proposing formation of an alliance or anything along those lines, but a security condominium. This condominium would counter present Soviet military power and deal with the new Asian situa-

tion soon to be brought about by this combination of Russian quiescence and rising Chinese pugnacity.

Fifth, we must contend with the feelings of excessive cultural supremacy on the part of important Asian countries. China is one of them. Japan is another. Both Koreans are a third. I suppose Singapore as a fourth. These all turn out to be Confucian-containing cultures. There is a rising nationalism in each of them. It can only take an anti-American turn in all four, as for example is occurring already in Taiwan. We must not be impatient with this attitude. Rather we must warn these countries of the consequences of their acts but not lose faith with them as they emerge from integral nationalism into global interdependence.

Sixth, there is a danger that the United States could make too close a connection between economic and security problems. It often pays to treat them separately. Politics is, for negotiating purposes, still the universal solvent. The danger is that the other side of the negotiating table—I would draw attention to the South Koreans in this case—are increasingly in a position to call America's bluff on security and economic questions if put in the same pot. That would leave us with unpalatable and extreme policy choices among which we would not like to choose.

Lastly, it is impossible for me to speak of United States-East Asian relations *in abstract*. American policy toward our East Asia, and Japan in particular, must be placed in a larger context. In the years to come, we will have to do just that even more than we have in the past.

For one, the strategic triangle as it operates in Asia is now in a state of relative equilibrium, which implies a fairly lengthy period, other things being equal, of peace. Eventually, the triangle will be transformed and world politics will be very different. It is still the base of world politics, but within a couple of decades it will be transformed by the entrance of Japan, China, and Western Europe as relatively equal participants. This implies replacing the present American-centered security system in Asia with a multilateral balance of power system in which we are one participant and the holder of the balance but do not dominate the whole system.

For another, the center of gravity of American policy in Asia is going to shift south and west, as China, Southeast Asia, and India come more into policy prominence. As a result, we will devote our attention less exclusively to Japan than we do now.

For a third, the American domestic economic transformation—the unfortunate economic product of robbing Peter to pay Paul over the last decade must be faced in the next decade. That is going to be a very important conditioner of our approach to Asia—perhaps the most important of them.

Fourth, the United States is going to have to be continually preoccupied with non-Asian matters—not only with the Soviet Union but now also Central America and the Middle East, to say nothing of Europe.

Mr. NIKSCH. We are running behind schedule. I am going to limit the length of time for questions to about 10 minutes, but hopefully we can get a few good points into a discussion. I'll call on Mark Noland first.

Mr. NOLAND. I have two questions for the panel, and then I have a substantive question. My first question for any member of the panel concerns the cost of the U.S. troops in Japan. What is that cost—in dollars and yen?

Mr. CHINWORTH. The dollar figure I think presently for supporting half the cost quoted at \$2.5 billion, so I presume that full support would be in the neighborhood of \$5 billion. And again I turn to the more informed people in the audience—correct me if I'm wrong.

Mr. NOLAND. So that would be about 600 billion yen? And Japanese GNP is about 360 trillion? So that's 0.2 percent of GNP?

Mrs. FROST. The major issue is that it would require renegotiating the treaty and resubmission to the Diet, and everyone has wanted to avoid that. That's really much more significant than just the money.

Mr. NOLAND. Second question concerns Japan's costs of defending its sea-lanes up to 1,000 nautical miles?

Mr. CHINWORTH. To be honest with you, and I'm not being facetious, the Self-Defense Forces are so far from achieving their goals, I don't know if that's really a subject of discussion right now. And that's my perspective. That's the issue. Japan is so far from being able to achieve those goals, that——

Mr. NOLAND. So we don't know what the resource costs are for this policy that we're advocating.

Mr. CHINWORTH. And as Ellen stated, much of it depends on how you do it. Clearly, if you have a carrier task force, it's going to cost a little bit more than if you add 50 more P-3Cs.

Mrs. FROST. Still one percent of a very large number is still a large number.

Mr. NOLAND. Here's the question: Will all due respect to those who want to have a world in which the United States Secretary of State sometime in the future calls up his Japanese counterpart before making major foreign policy decisions. Currently, once a month when the U.S. Treasury has an auction, the U.S. Secretary of the Treasury calls his counterpart at the Japanese Finance Ministry and inquires how much Japanese insurance company money can be rounded up to buy American T-bills. Then he calls the Governor of the Bank of Japan and asks him how much official lending the Bank of Japan is willing to do in the form of intervening in the exchange markets for the same purpose.

The point is that we're in debt to the Japanese, and they're already calling a lot of shots in economics. And I get the impression that there's a disjunction between the economics community and the foreign policy community, who haven't really absorbed this.

Now Mr. Robinson says that the correct response is for the U.S. to get our macroeconomic house in order, which is precisely right. That requires no negotiating with Japan or anyone else. We can do it ourselves. But Kent Calder said earlier this afternoon that you can't do that without confronting the fact that the United States spends 6 percent of GNP on defense and Japan spends 1 percent. And if you're in a political system where you've ruled out tax increases as effective means of raising more revenue, then it's got to come through expenditure cuts, and the defense budget is one place to start looking. Now Ellen Frost says things aren't that bad; that

we should declare victory and stay. Admittedly being a bit provocative here, my question is why don't we declare victory and come home? Michael Chinworth says the reason we don't is because we're buying markets, because if we pull out, the Japanese are going to go into a power vacuum and they're going to buy these markets. But the discussion this morning made it sound like we haven't bought any markets, and if we did, they were at very high cost. And it sounds like from this morning's discussion, if anything, we bought the enmity of these people who sort of regard us as a bunch of imperialists.

Mr. NIKSCH. Are you saying come home from the Pacific, or coming home from everywhere?

Mr. NOLAND. Well, we're talking about the Pacific here and we have a particular focus on Japan, where I think the case for this is stronger than it is for Europe. Ellen Frost says we're doing it because other people want us to stay for their own reasons, because they can play us off against the Soviets or something like that. Again, that's not a very convincing reason to me why we should be spending our money. We should be spending our money according to our own interests not others. Tom Robinson puts forth this big agenda in which the United States can do all these things in the Pacific Basin, and they sound really good. My question is would not a measured reduction in the U.S. military commitment to East Asia be consistent with meeting many of those things on that agenda? What is necessary for meeting that agenda? What is the necessity of having all these troops in East Asia to meet that agenda? Why shouldn't we just declare victory and come on home?

Mrs. FROST. Could I lead off? I didn't mean to suggest that the fact that others want us to stay is the only reason we should stay. I apologize if I created that impression. The Soviet Union, which is still our major potential adversary, is a Pacific power and a European power. The United States has two coasts—Pacific and Atlantic. There isn't a single major element of our global defense network that isn't tied one way or the other to the Western Pacific. It isn't that you can just pick up a piece of it and take that part home. That's why I think you got the question about Europe. It's very much a part of whether we want to play in the global super-power game. Having said that, I do think that we shouldn't freeze our current force posture in Asia and say, "This is a symbol of our commitment and we can't change it." I think it all depends on how a reduction is carried out. If it's carried out in a whinny spirit that we can't afford this anymore and it's all your fault, you Asians, because you're unfair. And we want to continue consuming at home, so we can't have these troops there." I think that's just the worst thing we could do to ourselves as a global power. Instead, we should sit down with the Japanese and our European allies and say, "Well, let's take a look at the threat. Let's take a look where we think the Soviets are going. Let's take a look particularly at what this fancy technology that we all paid for can do. Maybe it can carry out some of the same missions with a readjustment of forces or a reduction of forces." Then we can jointly announce gradual adjustments in our force posture as we go. We don't save any money doing that unless we demobilize people. But I think we could save some money here and there—for example, by coordinat-

ing our three military services, which insist on having all their own systems and not cooperating with each other. Better management in the Pentagon can save us some money, but we should also look at our forces in Asia and Europe and see if we can't save some money there. But it ought to be done with these broader political factors in mind, and very much as a member of a global alliance system.

Mr. NIKSCH. Any other comments? Let's have a question—Michael, do you want to say something?

Mr. CHINWORTH. Well, I was going to say there is a disagreement over the extent of the Soviet threat in the Pacific. I'm of the persuasion that the Soviet military will indeed use military threats at the very least for political gains if the perception is that they can get away with it, and consequently, it does require a certain prudent military presence in that area to ensure the ability of the U.S. to pursue its regional interests and help its allies avoid possible coercion.

Mr. NOLAND. The question here then is that presumably the Soviets are a threat, and the Japanese also perceive them as a threat. The Japanese are a lot closer to them than we are. And presumably the Japanese would be perfectly willing to do what is necessary to guarantee their own safety. If the Soviets really are a threat and the Japanese are tough guys as we've been hearing about all day long, then why do they suddenly think the Soviets are going to turn into a nation of 140 million Quakers? We have nuclear weapons. We tell the Japanese we have nuclear weapons. You take care of your own conventional defense. You stick Cruise missiles around your islands——

Mr. NIKSCH. Tom, did you want to——

Mr. ROBINSON. This is the subject of another whole conference. The American military presence in Asia is both scattered and absolutely minimal. It is a tripwire—on ground, sea, or air—and is nowhere able to deal by itself with the Soviet Union in any regional conflict. If you want to go below the minimal level, then you can pull forces back.

Second, power is a perceptual variable. If the Asians perceive that we are no longer an Asian military power, they will take actions. Maybe the Japanese will rearm to beat the band as a result. Do we really want that? That is the question. Power in Asia is something that must be integrated with power in other regions. The United States cannot withdraw from one area of the globe and still maintain its stance as a global power or in other regions. If you want us not to be a global power, fine. We'll not be a global power. But it is impossible to withdraw from Asia and stay in Europe or in the Middle East, for example. The proper analogy is not a house of cards, but a seamless web. It must remain that way if the United States wants to remain a global power.

Mr. NOLAND. If the United States wants to be a global power, then it has to figure out some way to pay for it, and that's something we haven't done.

Mr. NIKSCH. Let's take a question from Ira Wolf.

Mr. WOLF. Two comments on all this. One is that we have to get our own house in order first, and Ellen Frost alluded to this. With a \$300 billion defense budget, if we got our defense house in

order—and I'm not talking about toilet seats in this case, but anything ranging from base closing to true integration of weapons systems—we're not talking of a savings of \$1 or \$2 or \$3 billion. We're talking about massive savings that would make a truly dramatic change in the U.S. budget picture. The other thing relates to withdrawing from Asia and the whole burden-sharing argument. We're paying for it, we're paying for what we're getting. We have very different defense and security goals in Asia than the Japanese have; certainly very different from what the Philippines have, and we're paying for those, Ambassador. Mike Mansfield talks until he's blue in the face trying to explain that we're not paying to defend Japan *per se*. That's our western most line of defense, so to speak. If we're going to withdraw, if there's a reason for it, maybe withdrawal is the logical next step in a policy. But it should not be done in response to "let them take care of their own burdens." Maybe we're talking about a total reappraisal of our security requirements in Asia, but any withdrawal or cutting should have a policy contest.

Mr. NIKSCH. I'm going to have to cut this off, because we are running behind a schedule, and we do have another panel. So at this point, I would like to thank our panelists for their very interesting presentations and thank the questioners also during the discussion. We'll now adjourn and move to our next panel.

PANEL 6.—U.S. TRADE STRATEGY TO OPEN EAST ASIAN MARKETS

DISCUSSION LEADER: Stephen D. Cohen, School of International Service, American University

COMMENTATORS:

Rufus Yerxa, Assistant Chief Counsel, Committee on Ways and Means, U.S. House of Representatives

Peter Allgeier, Assistant U.S. Trade Representative for Asian and Pacific Affairs, Office of the U.S. Trade Representative

MODERATOR: Raymond J. Ahearn, Specialist in Asian Affairs, Congressional Research Service

Mr. AHEARN. The discussion leader for our last panel today is Stephen D. Cohen. Steve is a professor in the School of International Service at American University. His teaching and research specialty is international economic relations, with an emphasis on foreign trade policy and international finance. He has published widely. Among his recent books are *The Making of U.S. International Economic Policy* and *Uneasy Partnership: Competition and Conflict in U.S. Japanese Trade Relations*. Dr. Cohen is also a consultant to the Washington Analysis Corporation and several U.S. Government agencies. Prior to joining the American University faculty, Dr. Cohen served as a staff member for the Commission on the Organization of the Government for The Conduct of Foreign Policy.

Our commentators need very little introduction to most of you here. Rufus Yerxa is the Assistant Chief Counsel of the House Ways and Means Committee and the Staff Director of the Ways and Means Trade Subcommittee. In this capacity, he has been absorbed in developing the Omnibus Trade Legislation over the past few years. Prior to joining the professional staff of the Ways and Means Committee in 1981, Rufus served as legal assistant to the

chairman of the U.S. International Trade Commission. Mr. Yerxa was educated at the University of Washington, the University of Puget Sound, and Cambridge University in England.

Our second commentator is Peter Allgeier. He's currently the Assistant U.S. Trade Representative for Asia and the Pacific. In this position, Peter is on the front-line negotiating with all the countries in Asia except Japan and China. He is a graduate of Brown University and received his masters degree from the Johns Hopkins University School of Advanced International Studies and his Ph.D from the University of North Carolina.

Without further adieu, let us begin with Steve Cohen.

STATEMENT OF STEPHEN D. COHEN, SCHOOL OF INTERNATIONAL SERVICE, THE AMERICAN UNIVERSITY

Mr. COHEN. For those of you who have been here all day, I guess the transcendent question to my presentation is whether I say anything new or different at all. In many respects, my paper is a synthesis of points that have already been made today, presumably the points that I agree with. In listening to some of the more heated debates that have come out during the day, I've yet to hear the word "ideology." In many respects, what people before were arguing about, and what I'm about to talk about now, has to do with economic ideology. For example, in thinking about what to write in this paper, there were two possible avenues of approach, both of which I in fact rejected. One, I could have been the pointy-headed economist and talked about economic theory, which presumably would have said these market opening measures are essentially useless and simply don't matter in the larger sense. On the other hand, I could have gone the micro-route and simply compiled a list of specific products, for which we need to press East Asian countries to open their markets.

I have, I guess, come out in the middle with a kind of eclectic approach. In many respects, the approach that I took is very compatible with the kind of discussions that I have heard since I got here. In many respects, on the surface I am talking about market opening measures. But I would suggest that market opening measures really are a symbol. In this case, a symbol of larger political and economic policies and priorities, because depending on one's ideology and one's priorities, these market opening measures are somewhere on a spectrum between being very important and being very unimportant. If one has a certain kind of ideology, one may simply say: let the market mechanism take care of all this. On the other hand, one might subscribe to the strategic theory of trade, in which there is a role for government intervention and in which comparative advantage and free markets are not necessarily the end-all in terms of formulating a wise trade policy. In some respects, the argument is about paranoia, whether we do need to respond to the Japanese. We are dealing with a kind of ideological debate as to whether things are fine at home and whether we should let the markets sort all of these things out. If you believe the answers are "yes," you probably won't like a lot of what I'm saying. Since mine is an eclectic approach, if you don't believe it, you still won't like a lot of things that I'm saying.

Again to get back to the idea of market opening measures—we're really talking about means or symbols to two larger ends: one, the return to equilibrium in the U.S. trade balance and in the U.S. current account, and secondly, enhanced U.S. international competitiveness. Both of these things feed into the question of how we restore equilibrium to our trade balance. In simple arithmetic terms, there are two basic choices. One, we can restrict our imports. Two, we can increase our exports. As an economist, I think it patently clear that the optimal way to address the problem is for us to increase our exports relative to our imports. And to some extent, as you will see, I think one way to do that is through the pursuit of market opening measures.

One other thing on the idea of moving towards adjustment of our trade disequilibrium: there's more than simple arithmetic involved in the policy debate. Maybe it's O.K. if we simply reach arithmetic balance, maybe it's not. The latter question gets into a lot of things that have been said before about composition. In theory, balance our trade accounts by increasing our exports of raw materials, cotton, coal, soybeans, etc. My personal feeling is that it is an inadequate, second-best approach to increasing our exports; the top priority should be in the high-value added sector of manufactured goods. This gets us back to the question of market opening measures.

In terms of the paper, I mention early on that we can deal with a few empirical things here, such as the trade balances and the trade numbers. But there are some very key abstract questions involved in market opening measures which I think really can't be proven definitively. These key questions are: Exactly how open are the markets in East Asia? Why are American exporters not doing better? How important are the markets in East Asia to the American economy? How much political capital should the U.S. Government be expending in trying to push these markets open?

Very briefly, in terms of the empirical side of things, if we're going to opt for export expansion, then East Asia, as I think someone indeed has suggested, is an excellent market for U.S. exports simply because it is, I think, clearly the most dynamic economic region in the world. It is growing fast. It is large, and perhaps one might add as well that East Asia accounts for a disproportionate share of the U.S. trade deficit. For those of you who are into statistics, four of the top six countries where we have a bilateral trade deficit are in East Asia. Roughly 62 percent of our trade deficit in 1987 was accounted for by the countries that we have been talking about today.

Let me shift to the next section in my paper where we get into the subjective issues. And that section simply is called "Why is U.S. trade unbalanced with East Asia?" There are two possible extremes which I want to mention and then just simply discard. One is Asian protectionism. The other is incredible incompetence on the part of U.S. exporters. I think the truth has to lie somewhere in-between. Many contributing factors are involved. In terms of dismissing the argument that East Asian protectionism is the critical variable here, let me simply suggest that if one looks at the U.S. trade statistics, we have a global trade problem, not an East Asian problem. As our trade balance deteriorated, it deteriorated with

virtually everyone, and it's hard to prove that there was some kind of disproportionate net deterioration in East Asia.

Let me mention, in the interest of time, just three more important factors in terms of why the U.S. has a trade deficit with East Asia.

First, and again this is quite familiar for those of you who have been around for a while today, is macroeconomic policy. The long and short of it, and here I do have to revert to economic theory, is that until the United States does something about its lack of savings relative to its budget deficit and investment, this country is going to have a current account deficit and a trade deficit. We do need to do something about our macroeconomic policy. It doesn't necessarily have to be increased taxes or reduced budget deficit. If suddenly we passed the peak of yippie activity and we start becoming a nation of savers, that would be quite adequate to get the macroeconomic policy situation in a mold that we could in fact see a major correction in our trade deficit. When I get to the policy recommendations, I will come back to this.

Exchange rates are a second factor. I guess the basic question here is which exchange rate and which date. If we're going to talk about bilateral Japanese-U.S. trade equilibrium, and maybe we shouldn't be, then even at 120 yen per dollar, I do not think we are even close to an equilibrium dollar-yen exchange rate. If the yen depreciates further relative to the dollar, all this business about exchange rates bailing us out goes out the window.

Exchange rate changes will not be a panacea if we don't get our macroeconomic policy house in order. So those of you who wonder why the trade deficit persists despite all the dollar depreciation, it's macroeconomic policy disequilibrium. There is a disequilibrium within the United States. That's why so many people have been referring to it.

A third cause of the U.S. trade deficit with East Asia is trade barriers. The existence of barriers is of importance, and it certainly has to be mentioned given the subject of the paper that I was asked to write with reference to trade barriers in East Asia. The first and most obvious thing that has to be said is that much depends on what country is being looked at. I don't think we really have to talk about Hong Kong and Singapore as countries that have imposed significant import barriers to U.S. goods. When we talk about Taiwan and Korea, we get into two countries that presumably do have more barriers against U.S. goods. On the other hand, thanks I think in part to the gentleman on my right, there clearly has been some success in getting these countries to eliminate or reduce barriers that the U.S. Government has requested. So the mere fact that there have been barriers might be the bad news. The good news is these barriers indeed have been to some extent reduced.

Another factor in terms of imbalance with East Asia, and this rates as a whole separate section, is Japan. Japan, to me, towers over the other countries in East Asia in two ways: one, the actual trade balances and two, Japan's past, current, and future impact on the performance of the American economy. I quote a gentleman from Singapore in the paper, who says that "the combined size of the four NIC's barely exceeds 11 percent of the Japanese econo-

my." Assuming that he's correct, I think that is a good indicator of the kind of proportions that we are talking about. The fact of the matter is in looking at Japan's economic policies, they have in part been successful through their use of industrial policy—an industrial policy that has had as one of its components an effort to minimize imports and maximize exports. And that policy I think has very clearly showed up in terms of bilateral relations and indeed, the bilateral trade deficit. In asking whether the Japanese market is open or not, we could create another conference. Let me just simply suggest that, to this date, American companies tend to have an inordinate difficulty in exporting as opposed to investing in Japan—an inordinate difficulty in exporting to Japan as opposed to exporting to all other countries. Competitiveness does not seem to be a sufficient factor in order to be successful in exporting to the Japanese market.

In talking about Japan as a factor in our imbalance with East Asia, let's bring in the NIC's now. Up until very recently, the NIC's have been just about as unsuccessful as we have in exporting to Japan. Now maybe that's because the NIC's don't understand the Asian mentality and therefore haven't been able to crack the Japanese market. My conclusion is the Japanese market has been the independent variable.

The statistics in recent months are very interesting in terms of the percentage increases in NIC and European exports to Japan. It may well be that a major fundamental change is taking place. It may be temporary, based on exchange rates. It may simply be that, to paraphrase what Ellen Frost said, a big increase in a small number is still a small number. And if you look at the percentage increases of NIC exports to Japan, it's in one of my footnotes, even a 50 percent increase, which I think Korea enjoys, comes out to a rather small number in dollars and cents terms.

The other important point to emphasize here is that one of the reasons the United States has bilateral trade deficits with the four NIC's is that they have not been able to sell in the big and geographically proximate Japanese market. In some respects, Japan has been a deflector of NIC exports here because our market is not only arithmetically bigger, it has been geometrically more open to NIC exports than has the Japanese market. So once again, in an indirect capacity, Japan has a role to play in our trade problems in Southeast Asia as a whole. And there's all kinds of data here that I won't bore you with that show how these countries have sent very large percentages of their exports to the U.S., how they have had big surpluses with us. But at the same time, the NIC's have had bilateral deficits with Japan—at least those that are not major raw materials exporters, such as Indonesia.

Let me switch to another major topic here that I call the benefits and costs of U.S. market opening initiatives. To summarize, there's not a great deal of benefits, at least once you get beyond Japan, in terms of targets of opportunity. One could look at the annual report of the U.S. Trade Representative's Office that catalogues foreign trade barriers. The Japanese section is always quite voluminous. Hong Kong and Singapore don't even appear. If you look at the existing barriers in Korea and Taiwan, as listed in this presumably official listing of trade barriers, their trade barriers are there

but hardly the kind of thing that's going to make a major dent in \$160 billion multilateral trade deficit or in a big bilateral deficit. So we've got, I would say, marginal targets of opportunity in terms of beating up on the NIC's. We've also got problems with countries like the Philippines that have legitimate balance of payment constraints in terms of what can be opened up.

Does that mean we should retrain our negotiators to do something more positive, instead of beating up on Asian countries? No, is my answer. And the reason for that assertion is both economics and politics. On the economic side, it is a positive sum game if we allow consumers in Southeast Asia to have access to cheaper, better produced goods. It's also a benefit to exporters. So as someone who basically believes in the flow of trade, I've got no reason to oppose the U.S. Government to some extent forcing the NIC's and Japan, etc. to do things they should have done in the first place, namely, open up their markets. One also could look at empirical evidence. The market opening measures, at least outside of Japan, do work. American passivity in terms of not responding to the fact that over a 10- to 20-year period, Japanese market opening measures do very little is something that stuns me. However, in the case of the NIC's there does seem to be some cause and effect relationship between market opening measures and increased American exports.

From a political point of view, there's probably an even better case to pursue market opening measures in terms of cost effectiveness. If American companies, workers, and members of Congress don't think the "liberal trade system" is working, then we've got some real problems, assuming you want the maintenance of a liberal trade program. If you want to do away with the liberal trade policy, you probably should argue, let's let other countries maintain their barriers and have Washington tell American companies and unions to drop dead when they come in with their individual appeals. But trade policy is ultimately a political process. If key constituents in the domestic side of things think they are being had, and that the system is stacked against them, the political pressures to change that system, that is, to go more protectionist, could very well hit critical mass.

In many respects, the idea of more aggressive market opening measures such as self-initiated 301s—all have had a very useful political purpose. The Reagan administration adopted this trade aggressiveness in the fall of 1985, to calm down the Congress and to dispel the growing belief that the free marketeers in the administration were so out of touch that Congress had to take over in order to establish a rational trade policy and a level playing field. In many respects, things like the wonderfully worded "Strike Forces" have been symbols that the administration is going to heed the legitimate complaints of key constituencies that are either being hurt by imports or in terms of the paper here, who can't get into foreign markets because of foreign barriers. If one looks at the proposed 1988 omnibus trade bill, one sees very clearly that the Congress wants the Executive Branch to be more aggressive. If the Executive Branch continues to reject this notion, then again I think we could hit critical mass with the move towards a more protectionist trade policy.

In terms of ideology, Japan, and the rest of Southeast Asia (minus Hong Kong), and most of the rest of the world simply do not have the kind of love affair we seem to have with comparative advantage and liberal trade. Maybe that's the fault of academic professors that inculcate American college students with the alleged wisdom of comparative advantage. Even the notion that the NIC's have gotten where they are through free markets and through free trade is vastly oversimplified—an argument that I developed a little bit more in the paper here.

Let me just try to sum up the policy recommendations. First, keep in mind my own ideology that free markets are nice, and comparative advantage is nice, but they may not provide sufficient leverage to compete effectively with countries that curiously are concentrated in Southeast Asia—specifically, countries that have developed a very unusual blend of government-business cooperation. Somehow or other, Southeast Asia has almost monopolized success in learning how to have government and business work together in a harmonious and efficient manner. Japan led the way, and I think that anybody who believes that the free market is responsible for Japan or any of the NIC's (minus Hong Kong) is simply naive. To some extent, we probably should adopt some of this business-government cooperation—the idea that industrial policy is dirty and totally anathema to the American system is not only wrong but it flies in the face of reality. Ellen Frost mentioned DARPA. It probably isn't attuned enough to the commercial side of things, but clearly we do have a set of industrial efforts, not industrial policy. The thing is they're disjointed and don't have as their objective commercial economic strength.

I think that we need to enhance high-value added goods as our export sector. I think the idea of getting our macroeconomic house in order is absolutely critical.

In terms of market opening measures, let me suggest the semiconductor agreement with Japan as a possible prototype of a new generation of such measures. The most interesting thing to me on the semiconductor pact was the quasi-agreement that American semiconductors should rise to a preagreed market share in Japan. This arrangement, I think, finally recognizes that if you don't have market access in Japan, American companies or any foreign company, are put at a major disadvantage. One of the big mistakes that our basic manufacturing industry made in the 1970's was to think that there was no problem in giving their Japanese competition a protected market from which to operate. The high-tech sector, at least semiconductors, seems to have learned from the mistakes of their brethren in the basic manufacturing. The U.S. Government at long last may have learned from the failure of Japanese liberalization measures to do anything. Essentially what this market opening pact says is we expect "x" percent of the market. Don't give us any liberalization measures. Don't give us any proclamations. We will just look at the arithmetic of increased exports.

In terms of market opening measures Japan is far, more important than any of the other countries. I'm not hung up on the idea that the bilateral trade account has to be in equilibrium. I'm not happy if we balance our accounts with Japan by increasing grapefruits and oranges. I do think our high-tech industries have to have

better market access there. And by extension, it's probably not a good idea to allow the NIC's to further develop the infant industry trade policies that were so successful in Japan. I don't think it's neomercantilistic, and I don't think it's dangerous to our alliances, if our trade negotiators do push on the idea of market access.

Let me just conclude with another reference to ideology and priorities. Our system has been hung up on national security. Somehow it's quite legitimate in Washington to talk about extending American power through armaments. For some reason we don't talk about the use of economic strength as a way of projecting American power overseas. And I think to the extent that one believes that could and should be done, the need for further market opening measures becomes obvious.

Mr. AHEARN. Thank you, Steve. Your statement will be inserted in the record.

[The statement follows:]

PREPARED STATEMENT OF STEPHEN D. COHEN, SCHOOL OF INTERNATIONAL SERVICE,
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THE POLITICAL ECONOMY OF EXPANDED U.S. MARKET ACCESS IN EAST ASIA

Efforts to expand the access of American goods and services to the growing markets of East Asia are only partially about export policy. The process is mainly about competing political and economic values and priorities.

U.S. trade flows can be precisely quantified. Beyond the statistics, however, there is little that is non-controversial and unequivocal about the dynamics of U.S. market access in East Asia. All of the major questions are open to debate: exactly how open are the markets of East Asia, why are American exporters not doing better, what economic changes would enable them to do better, how important to the overall American economy are increased exports, and how much political capital should be expended in seeking greater access for American goods and services in East Asia.

With this dual level of reality in mind, this paper opens with a relatively brief examination of the facts and then moves on to more extensive (and more subjective) analysis of the importance of opening East Asian markets to the larger goals of enhancing U.S. international competitiveness and eliminating the U.S. trade disequilibrium. The basic thesis of the study is that a dynamic export sector, like charity, begins at home.

The U.S. and East Asian Economic Positions

There are two distinct methods by which the unsustainable large U.S. merchandise trade and current account balances can be returned to equilibrium: 1) a significant unilateral reduction in imports, or 2) a significant boost in exports. The first option is patently undesirable, for it would simultaneously injure the American economy and the global economy through reduced growth and efficiency. The second option could be accomplished within the context of continued growth in both domestic economic activity and in world trade, as well as the enhanced efficiency and price stability inherent in the international specialization of labor.

With a trade deficit of \$171 billion in 1987 and a projected trade deficit of about \$150 billion in 1988, American exports have a lot of catching up to do if the adjustment process is ever going to work. Some markets, such as Europe and Canada, are good candidates for increased overseas U.S. sales. Others, such as Latin America and the Middle East, offer less potential because of their own balance of payments constraints.

East Asia offers an excellent opportunity for increased American exports because it collectively represents the most dynamic regional market in the world. Japan has risen from the ashes of World War II to become the world's second largest economy and an industrial super power with a per capital GNP (in current dollar terms) higher than that of the United States. The growth performance of the four newly industrialized countries (NICs) of Asia—Hong Kong, South Korea, Singapore, and Taiwan—has been spectacular: over the past 25 years, combined real growth in

these four countries has exceeded 10 percent annually.¹ Even more dramatic economic change has been unleashed by China's introduction of market-based economic reforms; from 1980 to 1986, China's economy grew in real terms by 8.6 percent per year on average.²

Other economies, such as Malaysia, Thailand, and India, are potentially the NICs of the future. Australia and New Zealand already are advanced, high income economies. East Asia's collective GNP is now above \$2 trillion, or one-half of the U.S. GNP, compared to only \$700 million in current dollars, or one-third of the U.S. GNP, just 20 years ago.³

While taking pleasure in this empirical demonstration of how the market mechanism, private ownership of industry, and supportive official policies by capitalist governments can put planned economies to shame, the United States is concerned about the relatively poor U.S. bilateral trade performance in East Asia. U.S. trade statistics for 1987 reveal that four of the six largest bilateral U.S. trade deficits were with Asian countries.⁴

U.S. bilateral trade balances, 1987

	<i>Billions</i> \$171
World total.....	\$171
Japan.....	59.8
Taiwan.....	19.0
West Germany.....	16.3
Canada.....	11.7
South Korea.....	9.9
Hong Kong.....	6.5

All in all, the East Asian countries accounted for 62 percent, or \$106 billion, of the total U.S. trade deficit in 1987. Collectively, these countries took 26 percent of U.S. exports and supplied an impressive 41 percent of all U.S. imports.⁵

Why Is U.S. Trade Unbalanced with East Asia?

Construction of exact, unequivocal cause and effect relationships are seldom possible in economics. It is unlikely that either of two possible extremes—Asian protectionism or American ineptness—are the sole explanation for the relatively poor U.S. trade performance in this region. A brief survey of the more important contributing factors follows.

That much of the problem rests with the United States can be deduced from the simple fact that this country has a GLOBAL trade weakness problem: our trade position has deteriorated on an across the board basis. While domestic growth rates and export increases may be unprecedented in the western Pacific region, there is nothing special in the fact that Asians are enjoying a large trade surplus with the United States. Nor is there anything extraordinary in the degree to which they impose formal barriers to would-be American exports.

The single most important reason for the large and continuing multilateral U.S. trade deficit is the inadequacy of internal savings relative to the government's budget deficits and private investment. In terms of economic theory, the current account will always equal savings minus net governmental spending and minus investment. In common sense terms, we as a country are consuming more than we are producing, the difference being made up by an excess of imports over exports that is financed by massive net capital inflows. In mid-1988, the continued expansion of the American economy is having the dual effect of attracting imports and constraining the growth of exports, even after considerable dollar depreciation since March, 1985. With capacity utilization rates in many key industries at relatively high levels, many American companies simply have limited merchandise left over after meeting strong domestic orders.

The key to external U.S. trade equilibrium, simply stated, is a return to internal equilibrium, i.e. a cessation of our continuing preference to live beyond our means. This will require a combination of more savings and lower Federal budget deficits.

¹ Address of John C. Whitehead, Deputy Secretary of State; press release dated April 21, 1988, p. 2.

² *Ibid*

³ Address of Ambassador Clayton Yeutter, U.S. Trade Representative; press release dated March 2, 1988, p. 1.

⁴ Data source: *Business America*, April 25, 1988, p. 6.

⁵ Address of Peter F. Alleger, Assistant U.S. Trade Representative; press release dated March 25, 1988, p. 1.

Exchange rates are a secondary factor in the U.S. trade deficit, but they still enter into the picture. It is the author's opinion that given continuing reductions in Japanese industry's production costs, the willingness of many Japanese companies to accept minimal (or even zero) profits as a way of retaining market share in the United States, and relatively price inelastic demands in both countries for each other's goods, a 125 yen is still undervalued, its 50% appreciation against the dollar notwithstanding. It is still too early to tell whether the administratively induced appreciations of the Taiwanese dollar and the Korea won vis-a-vis the U.S. dollar have been adequate in market terms to compensate for the relatively greater increases in the international competitiveness of these two countries.

American export prowess and zeal suffer from a number of disincentives that are beyond the scope of this paper. They include such official constraints as export controls, relatively limited concessional export financing, and widespread corporate preference for selling in overseas markets through foreign direct investments.

Import barriers are a final, but not critical, factor in reducing U.S. sales of certain goods in Asian markets. On an official or overt basis, however, Asian trade barriers do not appear noticeably more damaging or discriminatory than those of other geographic region, including Western Europe. The markets of Hong Kong and Singapore are almost completely open; indeed, they represent the closest thing we have to genuinely free trade policies in the world today. Furthermore, U.S. trade negotiators have been successful in obtaining the removal or liberalization of trade barriers elsewhere in Asia. For example, Taiwan has reduced tariffs on a wide range of products requested by the Reagan administration and eased market access for beer, wine, cigarettes, and insurance sales, all in response to U.S. demands.

The Special Problem of Japan

The Japanese economy towers over all of the other economies of Asia. Japan's trading patterns are a crucial variable, not only in the United States' trading relations with the smaller economies of Asia, but in the future performance of the American industrial sector. In short, U.S. trade policies should establish as a top priority the implementation of a major shift in Japan's demand for the tolerance of imports of U.S.-made manufactured goods. With the possible exception of China, all of the other countries of the region simply have too small an economy to become a genuine "new Japan". When calculating export opportunities and foreign competition in general, we should note that "the combined size of the four NICs barely exceeds 11% of the Japanese economy."⁶

Japan's economic success is partly linked to a flexible, far-sighted industrial policy that in turn partly was and is based on maximizing exports and minimizing import competition (at least until a targeted industry is sufficiently strong to be considered a world class competitor). This paper cannot dwell on the complicated issue of whether Japan's markets are really "open" or what is an "acceptable" U.S. bilateral trade deficit with that country.⁷ The central point is that the data provide ample evidence that American industries have had a far more difficult and unsuccessful experience in exporting to Japan than to any other country, in terms of both volume and market share.

The argument that is to be emphasized here is that increased penetration of the Japanese market—by whatever means—is of critical importance to the long-term competitiveness of the U.S. high-tech sector. A key mistake of the American basic manufacturing sector was not realizing the strategic advantage that accrued to its Japanese counterpart by being able to operate from a protected home base. Failure of American high technology companies to successfully take the competitive fight to that market will bestow many benefits on Japanese producers. These benefits include the opportunity to offset cheap export prices with high domestic prices, deny American producers the economies of scale that follow from successfully selling in the world's second largest market, and encourage Japanese companies to take investment risks in the pursuit of long-term rewards, i.e. global market domination. A key mistake of U.S. trade policy has been equating Japanese liberalization measures with a genuine relaxation of market access problems. It has been an especially costly mistake in view of Japan's extraordinary and successful commitment to competitive excellence in all major industrial sectors.

⁶ Richard Hu, "We NIC's Got Our Share of the Pie the Old-Fashioned Way—We Earned It," *The International Economy*, March/April, 1988, p. 81.

⁷ For a fuller discussion of these issues, see the author's book, *Uneasy Partnership: Competition and Conflict in U.S.-Japanese Trade Relations* (Ballinger Publishing Company, 1985), especially chapters 7, 8, and 9.

Japan's inhospitality to imports from the rest of Asia not only belies the assertion that U.S. export incompetence is responsible for the Japanese trade surpluses. It also is indirectly responsible for the Asian NICs' emphasis on exporting to the American market. Unless one wants to make the dubious argument that the NICs also have been singularly inept in trying to export to Japan, one deduces that Japan's heretofore impenetrable market (for manufactured goods) has caused a clear deflection of NIC exports away from the geographically close and very large Japanese market to the other side of the Pacific. In 1986, Taiwan's exports to the United States equaled 27 percent of its GNP, while the figure for Korea was 15 percent.⁸ The United States absorbs nearly 50 percent of Taiwan's exports, 40 percent of Korea's exports, more than 25 percent of Hong Kong's, and nearly 25 percent of Singapore's exports.⁹ On the other hand,

"The Japanese market, half the size of our market, absorbs less than one third of the value of U.S. imports from these four countries (\$19.8 billion in 1987 versus U.S. imports of \$61 billion) The U.S. absorbed 44 percent of the NICs' export growth between 1980 and 1987, while Japan absorbed only 9 percent of that growth."¹⁰

According to International Monetary Fund (IMF) data, while Hong Kong was enjoying a bilateral trade surplus in 1986 with the U.S. of \$8.1 billion, it was suffering a bilateral deficit with Japan of \$5.6 billion (exports to Japan were only 1.7 billion and imports were \$7.2). South Korea experienced a \$6.6 billion surplus with the U.S. in the same year, but ran a \$5.6 billion deficit with Japan.¹¹ To be sure, recent data indicate a big percentage upsurge in the NIC's exports to Japan, but it is too soon to be sure that this increase represents a secular trend. Furthermore, in evaluating these increases, it is useful to refer to the old arithmetic maxim that a big percentage increase in a small number is still a small number.¹²

Implicit in Japan's export numbers to the NICs is the fact that increased American exports to the other East Asian countries presupposes our businessmen's ability to dislodge the heretofore very successful Japanese commercial presence. Yen appreciation or not, Japanese industry will not willingly or easily yield market share in this region to its American competition. The Japanese marketing network is firmly entrenched, Japan has an excellent system of subsidized official export financing, and the replacement by Japan of the U.S. as the largest foreign aid donor in the region will give the former additional influence in these markets.

The Benefits and Costs of Further U.S. Market Opening Initiatives

In the larger equation of enhancing the structural competitiveness of American industry and achieving equilibrium in the U.S. trade account, removal or relaxation of the remaining formal barriers in East Asia is of marginal significance. A review of the annual report on significant foreign trade barriers issued by the U.S. Trade Representative's Office does not produce an extensive or intensive list of restrictions damaging to U.S. merchandise export interests maintained by East Asian countries (except in the case of Japan).¹³

The existence of limited targets of opportunity, however, does not necessarily mean that increased U.S. efforts to further open up Asian markets are unwise, or are not cost-effective, or are unattainable given the existing level of American influence. In fact, there are both economic and political reasons for advocating that official efforts at additional trade liberalization in East Asia continue at levels at least as intense as currently exist.

If other countries, in Asia or elsewhere, maintain tariff or non-tariff barriers to the inflow of foreign goods and services, there must be an assumption that local producers are relatively inefficient. A relaxation of such barriers presumably would result in additional exports from the country of the more efficient producer. Efforts by the U.S. Government to negotiate the reduction or elimination of specific foreign

⁸ Address of David C. Mulford, Assistant Secretary of the Treasury; press release dated November 17, 1987.

⁹ "U.S. Trade Policy Toward Newly Industrializing Countries in Asia"; unclassified U.S. Trade Representative memorandum dated April 20, 1988, p. 1.

¹⁰ *Ibid.*, p. 2.

¹¹ International Monetary Fund, *Direction of Trade Statistics 1987 Yearbook*, pp. 217, 250.

¹² An article in the *Wall Street Journal* of June 7, 1988 noted a 27% sales increase in imported cars in Japan in May, 1988 in unit terms, this represented an increase of only 2,059 cars. Similarly, an article in *The Financial Times* of March 23, 1988 reported that Japan's imports from South Korea had increased in value by an impressive 53%; a closer analysis, however, shows this increase to be only \$2.76 billion, an amount just a little above what the United States imports (globally) every business day.

¹³ See U.S. Trade Representative, *1987 National Trade Estimate Report on Foreign Trade Barriers* (Washington, D.C.: U.S. Government Printing Office, 1987).

trade barriers presumably follow from a well argued presentation by the domestic private sector that U.S. exports of a given product or service would increase if trade barriers were relaxed. In an optimal situation, the negotiated removal of a given barrier would be a positive sum game that results in increased efficiency in the utilization of the world's economic resources, enhance the well being of the importers of the cheaper and/or better product, enhance the sales and profitability of an American company, and help in a small way to reduce the swollen U.S. trade deficit.

The minuscule percentage reduction in this deficit resulting from even an extensive relaxation of formal Asian trade barriers is beside the point. If the American business sector and the Congress perceive that legitimate grievances against unfair foreign trade practices cannot or will not be successfully resolved, the political support for a liberal U.S. trade policy will erode.

The core philosophical argument between the Congress and the administration concerning new omnibus trade legislation in the 1986-88 period concerned the need to restrict presidential discretion in dealing with unfair foreign trade practices. For understandable reasons, many members of Congress perceive a natural bias of presidents towards global statesmanship and liberal trade and away from helping local producers cope with intense import competition and foreign import barriers.

The more aggressive trade policy adopted by the Reagan administration since the fall of 1985 (including numerous bilateral initiatives to increase market access in East Asian countries) can best be understood as an effort to demonstrate to Congress that no major change in existing trade statutes is necessary. More specifically, this more aggressive trade stance was designed to demonstrate an Executive Branch posture that the U.S. could no longer afford to turn the other cheek in view of its massive trade deficit. It was correctly presumed that efforts to attain a "more level playing field" would prevent an unwanted change by Congress in statutory language that would reduce the president's flexibility in determining when and how to respond to a given trade dispute.

Market opening initiatives, however, are not only a means to the political end of responding to legitimate constituent complaints. When coupled with an exchange rate realignment and enhanced corporate marketing efforts, they can produce a quick increase in American export sales and some reinforcement of political faith in a liberal trade policy.

The resort to unilateral protectionism is still not a clear and present danger in U.S. trade policy. Remarkably few politicians have argued that import barriers are an appropriate or wise means of eliminating what is the biggest trade deficit the history of the world. A dangerous escalation of trade tensions most likely would result from a growing sentiment in Congress that some type of all-inclusive formula for achieving "reciprocity" must be implemented, one that threatens other countries with automatic retaliation if they do not accede to American market opening demands. Increased foreign willingness to accept more U.S. imports through further market opening measures would reduce the desire in Washington to threaten our trading partners with retaliation.

Progress—or lack thereof—in securing further market opening measures, be it on a bilateral basis or in multilateral trade negotiations in the General Agreements on Tariffs and Trade (GATT), will also be a barometer in determining which of two broad economic policy philosophies will guide the evolution of the international trading system. It is the author's view that most countries of the world, and the overwhelming majority of East Asian countries, do not share the sometimes extreme and naive American preferences for the twin virtues of an unfettered market mechanism and comparative advantage. The current economic success stories, Japan and the East Asian NICs (with the exception of Hong Kong), as well as China and the potential Asian success stories of the 1990s, are simply not testaments to the magic of the marketplace in the domestic and external economic spheres.

The absence of continued outside pressure to force the exposure of favored, or targeted, industries in Asia will serve to enhance and perpetuate the industrial and protectionist policies that in fact have well served Japan and the NICs (minus Hong Kong). Americans are slowly awakening to the implications of Japan's being a "capitalist development state" and not the mirror image of American-style capitalism. Most observers of the trade scene make the mistake of attributing the foreign trade successes of Korea, Taiwan, and Singapore to a liberal trade policy emphasizing export expansion and avoiding import substitution measures. The situation seems more complicated, inasmuch as the degree of government intervention varies with country and with time period. In the view of one scholar,

"In Korea, Taiwan, and Singapore, the evolution of the production structure and the composition of exports was not left to the market, but was the result of deliber-

ate government design. On balance, the exchange rate, the interest rate, the tax system, and public sector investment were not neutral factors subordinate to market forces in these cases; rather, they were...important instruments of development strategy. What seems to distinguish the East Asian development experiences is not the dominance of market forces, free enterprise, and internal liberalization, but effective, highly inter-active relationships between the public and private sectors characterized by shared goals and commitments."¹⁴

It is no coincidence that the above diagnosis perfectly describes the postwar Japanese economic recovery. The non-communist countries of East Asia arguably are the most dynamic group of economies in the world because of their remarkable success in developing an optimal balance between market forces, rewards to risk takers, and supportive governmental policies.

The United States faces a major policy dilemma. A perpetuation of the policy status quo is unlikely to allow any sustained and significant improvement in the American trade performance. A failure of the United States to move towards trade equilibrium would not be in the longer term interests of East Asia or the global economy as a whole.

Policy Recommendations

A more successful U.S. export performance in East Asia and elsewhere is most likely to occur in the wake of a two-tiered process. First, the U.S. Government must alter its macroeconomic policies, and it must convince other countries to minimize their trade barriers. Second, American corporations must produce and aggressively market goods and services that foreigners will buy because of uniqueness, price, quality, or after-sales service (spare parts, maintenance, and repairs).

Economic logic and empirical evidence demonstrate that outlays for automation and dollar depreciation are not by themselves sufficient to turn the United States into the low cost producer of the high value-added, state of the art goods that should be the mainstay of our export sector. The ever increasing pace of the internationalization of technology, emerging breakthroughs in computer-integrated-manufacturing, and foreign governments' subsidies present extraordinary challenges to the mettle of American business to export even in the absence of significant foreign import barriers.

In the area of macroeconomic policy, greater attention must be given to the still unassailable economic rule that a country whose savings is inadequate to finance its governmental budget deficits and business investment will perforce incur a deficit in its current account (net imports of goods and services). Without a reduction in the federal budget deficit and/or increased savings, the United States will be unable to eliminate its trade deficit without a consumption-retarding recession. With a new president and a new Congress next year, increases in federal revenues should be carefully considered.

In an atmosphere that emphasizes cooperation not adversarial feelings, the business community and the government should discuss at length the advisability and rationale of increased incentives for new investment and increased research and development. Such consultations should take place in the context of an acceptance of the notion that there is an appropriate role in the American system for a limited application of industrial policies in certain sectors under certain circumstances. In point of fact, the United States has long operated a disjointed series of industrial policies, ranging from Department of Defense and NASA procurement, to agricultural subsidies, to the partial federal funding of SEMATECH, the cooperative industry venture to develop advanced methods of manufacturing semiconductors. The government also should encourage a more resolute determination by corporate America to produce better and cheaper goods by informing the private sector that it will not be bailed out from fair foreign competition.

U.S. trade policy must be guided by three overriding considerations in dealing with the new business challenges in East Asia and elsewhere. First, we should not lose sight of the fact that our half century as the chief architect of a liberal international trading order has brought great economic advantages to both the international community as well as to ourselves. Second, the first best solution to reducing our trade deficit is increased exports, not reduced imports. To this end, U.S. Government officials should extol the virtues of consumer-led, as opposed to export-led, growth to their East Asian counterparts.

¹⁴ Colin I. Bradford, Jr., "East Asian 'Models': Myths and Lessons," in John Lewis and Valeriana Kallab, editors, *Development Strategies Reconsidered* (New Brunswick, N.J.: Transaction Books, 1986), p. 123.

Third, we must not delude ourselves that other countries share beliefs in the market mechanism as fully as we do. There needs to be a better understanding of the implications of the unprecedented success in Japan and the NICs in fusing together governmental and private sector cooperation. We should spend less time in worshipping the invisible hand of the marketplace and devote more time to studying the possibilities of adapting some of the East Asian business tactics and economic policies that would be compatible with our own economic and social values.

If the U.S. Government wants to pursue market opening measures in East Asia, as it should, it must be prepared to accept criticisms that it is forsaking multilateralism for bilateralism and that it is making unreasonable demands on foreign governments. A possible prototype of future market opening demands based on direct promises of increased market share, not indirect liberalization measures, is the alleged commitment by Japan in 1986 to double (over a stipulated time period) its market share of American-made semiconductors. U.S. officials must also be prepared to be accused of bully boy tactics, even if a foreign government is quietly encouraging U.S. pressures to force it to do things that are politically difficult but economically desirable.

If the U.S. Government wants to pursue conventional market opening measures, it currently has adequate legislative authority, mainly in the form of Section 301 of the Trade Act of 1974. The provision allows for retaliation against foreign trade practices that are discriminatory and restrictive towards U.S. commerce. Congress's effort to expand Section 301 in the 1988 omnibus trade bill perfectly illustrates its belief that the Executive Branch should intensify the campaign against foreign trade barriers.

The first guideline of such efforts is to recognize that there are differences in the situations in each country and different tactics must be employed. There are no extensive trade barriers encountered in Hong Kong and Singapore. Some of the weaker East Asian countries, such as the Philippines and Thailand, can justify at least some import barriers because of weak balance of payments positions. Japan is not only the largest market by far, it also claims to be the most open. This is still a dubious claim for the country whose technological and marketing prowess make it the most formidable competitor for many American companies. U.S. pressures for market opening measures should not be switched to the more vulnerable NICs simply because of concern that antagonizing Japan might jeopardize continuation of the large inflows of Japanese capital that help finance the U.S. budget and current account deficits.

Failure of the U.S. high tech sector to wage a more intense and successful sales effort in the Japanese market risks a replication of what Japanese competition did to basic manufacturing in the United States (steel, automobiles, consumer electronics, etc.) Hence, government trade negotiators need to deal not only with overt barriers, but also indirect barriers inherent in the Japanese business system that make life very difficult for outsiders to penetrate; such indirect barriers include the distribution system, governmental sanctioned cartels, and the propensity of members of keiretsu to buy from one another.

The goal of increased exports to Japan is not simple neomercantilism or an arbitrary effort to reduce the size of the bilateral trade deficit. Rather, it is to reduce a significant advantage to our most capable competitor: the ability to shield favored industries from effective foreign competition despite countless symbolic liberalization programs. The latter inevitably placate American anger despite the continued absence of any direct, measurable results. (The curious American passivity demonstrated here may reflect the superficial official commitment to export maximization.)

The need for forcing market opening measures in South Korea and Taiwan is real, but is far less than in Japan. Fewer barriers and smaller markets mean less sales opportunities and a far lower probability that either will truly become a "new Japan." Nevertheless, it is not in our economic interest to encourage current and future NICs to utilize the infant industry strategy used so successfully by Japan (i.e. protecting new and favored industries until they are mature enough to hold their own against foreign competition). It is in our interests to urge them in the strongest terms to pursue liberal, market-oriented trade policies by systematically attacking their barriers and responding to their legitimate grievances about our trade barriers.

If anyone doubts that the U.S. still has the leverage to demand additional market access from these countries, he or she should refer above to the data presented on how important the American market is for their economy in general and export sector in particular. Whether or not we have the will and immediate need to use all of that leverage is the real question. Foreign belief that the United States is fully

prepared to accept the costs of at least a temporary closing of its import markets is an excellent means of accelerating the reduction of many of the remaining East Asian import barriers—without unilateral U.S. actions.

In some circles, it heresy to suggest that the U.S. should subordinate national security goals to trade needs. But we may need to take more political heat in East Asia and elsewhere in order to prevent a domestic political backlash that could produce undesirable U.S. import barriers. Furthermore, economic strength is now an important part of national security. The nature of international business has changed dramatically since the comparatively innocent years in the late 1940s when the GATT was founded. East Asia probably exemplifies this change better than any other geographic region.

The United States needs adjustments to its domestic macroeconomic policies, an industrial sector better able to innovate and to produce cheaply and well, and an increased national commitment to export expansion. The alternative is mutually costly (for us and our overseas friends) declines in the value of the dollar, the American standard of living, and U.S. international political power.

Mr. AHEARN. We'll turn now to Rufus Yerxa for his comments.

**STATEMENT OF RUFUS YERXA, ASSISTANT CHIEF COUNSEL,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES**

Mr. YERXA. Let me speak a little bit about what I see in the trade bill and in the trade arena being debated on the Hill right now that relates in large part to the subject of the market access paper you just heard. I think arguably the most important thing we could do in the next year to sort out all of this debate of how to deal with our trade problems in East Asia would be to get this trade bill behind us—not necessarily because provisions of the trade bill have all the final answers to the issue of market access, but because if we don't get it behind us, we're going to go through the debate next year all over again. We're going to spend the next couple of years with a lot of disagreement, and a lot of diffusion of the efforts of our trade negotiators who spend more time negotiating with Capitol Hill than they do with our trading partners. But I would also argue that what's in the trade bill is as good a blueprint as you're going to get on how to deal with the problem. You have to look pretty hard and come up with a pretty contorted reading of the trade bill to say that there's anything in there that is so massively trade-restricting or protectionist that it's going to result in a trade war. I think the conference produced a bill that's pretty much devoid of unilateral restrictions, and in the area of market opening measures, I think what the bill ends up emphasizing is reasonably sound. The section 301 amendments basically take on trade agreement violations—that is the major category they seek to address. In large part, our current policy since 1985 has been to retaliate against trade agreement violations anyway. The bill sort of makes that approach statutory. And when the bill talks about mandatory retaliation, you have to be very careful how you read it, because you'll find that "mandatory" is not exactly "mandatory". It's what Bob Strauss referred to as "more compulsory but not mandatory." There's lots and lots of qualifications and exceptions but I think the important point here is that the bill decided to emphasize section 301 and market access rather than market-restricting measures. I think that in most of the areas you look at—Section 201, for example—arguably there is as much that is trade-liberalizing as there is trade-restricting. It tends to emphasize adjust-

ment and giving relief to industries only if they demonstrate a need for a capacity to adjust as part of some section 201 relief program.

The other market access measures in the bill, it seems to me, emphasize what we ought to be emphasizing: high technology, intellectual property, and telecommunications. None of these special provisions mandate a lot of retaliation or restrictions, but they do mandate some kind of a negotiating process, which is probably something that Peter and the folks over at USTR would like to engage in anyway. There is a salesmanship job that they have to make because we compartmentalized all these things in the trade bill, and they now have to come up to us with these annual reports showing us exactly what they've done on telecommunications, exactly what they've done on intellectual property, exactly what they've done with super 301. But the net effect of it all, I think, is greater tools for market access without the kinds of automatic retaliation that people saw as dangerous in the amendments that were pending in the House and the Senate before the conference got together. So I think the trade bill in that sense is probably going to send the right signal to the world, but more importantly, the right signal to the American business and policy making community. And I would hope that we get it behind us, because if we don't, we're going to be back fighting all of these issues, including the Gephardt amendment and every other conceivable issue, in 1989.

The only other point I'd like to make about your paper—and I think it's a very good one, and I think a lot of your arguments are sound—the point I would make is that I totally endorse the statement you made about the need to continue these market access measures even if you don't see a direct benefit to the trade balance. That's not what the issue is here really. The issue is what you said, keeping some political stability in the whole trade policy process, but more importantly than that, demonstrating to American industry over what I think is going to have to be a course of 20 years that there really is some serious purpose to exporting. There really is some government effort behind it, not only providing some kinds of marketing assistance and things of that sort, but also aggressively attacking a trade barrier where we see it. Some European diplomats were in to see my chairman the other day and said "Gee, if you adopt this trade bill, we're going to adopt the same sorts of things you're doing—such as section 301. We're going to come after you for your textile restraints, and for other market restraints." The chairman looked at them and said, "Gentlemen, you don't know how welcome that'll be to those of us who believe in free trade". The point is that the system would work a lot better if countries really aggressively took on unfair barriers, and if the U.S. manufacturing and producing sector recognized that there is some purpose to undertaking a 20-year effort to build a market in Japan. Because if the Japanese try to close their market down at some point, the U.S. Government will be there aggressively trying to keep it open. I don't think you're going to see any immediate impact on the trade balance because of the trade bill, but that's an argument that cuts both ways. That's an argument for going ahead with it, because it obviously means that the trade bill is not going to result in a massive shutdown of the American market. I think

everybody now finally recognizes that America is not going to go down the road of protectionism. That just isn't where the future lies.

Mr. AHEARN. Thank you, Rufus. We'll turn to Peter, and see if he's looking forward to negotiating for another 20 years with our friends in East Asia.

STATEMENT OF PETER ALLGEIER, ASSISTANT U.S. TRADE REPRESENTATIVE FOR ASIAN AND PACIFIC AFFAIRS, OFFICE OF THE U.S. TRADE REPRESENTATIVE

Mr. ALLGEIER. Another 20 years! I was glad however to hear that Steve Cohen was not saying that I needed to go back to night school to learn a new career at this point. Since I also believe in comparative advantage, I will talk primarily about some of the comments that Steve made in his paper that bear directly on how we negotiate with the East Asian developing countries, since that is what I do.

First, not necessarily in the order in which these things appeared in his paper, he talked about the fact that most of the countries in East Asia, if not all of them, do not share fully our belief in the market mechanism. That is an important point to recognize. If you read their official statements, at the level of rhetoric everybody buys into the market system, free enterprise and free trade. But when you get down to very specific negotiations, you find that that is not the case. And it varies from country to country. Let me just mention a couple of specific instances. Korea, is a very interesting situation. Most of the senior economic officials in the Korean government have Ph.Ds in economics from the United States, so they have imbibed of our free market ideology, and to a certain extent they agree with it. Then they go back to Korea and that ideology conflicts with the political and economic reality that they face in Korea. But to a certain extent, they move along with the general free market ideology within those constraints. There is a tension, however, between these liberalizers and most of the rest of Korea—other officials, the press, the public, and so forth. And Korea's working out that tension right now. It's a sort of football game in which there isn't very much thrown and it's mostly a ground game; currently the game is going back and forth without either side scoring. And democratization is going to make the situation more difficult for the liberalizes, because as trade policy becomes an issue more generally and a more political issue in a place like Korea or Taiwan, more of the nonliberalizers are being brought into the discussion, and the scope of action that the liberalizes have enjoyed in the past is being reduced. When a liberalizes worked in a more authoritarian situation, they could negotiate agreements without having to go around and negotiate with the New National Assembly including opposition leaders. So we're finding especially in Korea and Taiwan, but I think we'll find it more in other countries too, a greater difficulty for those officials in those countries that would liberalize.

One also finds when negotiating with many of our partners in Asia that they find it very difficult to believe that we really want the market completely open, whether it's soda ash, or limes, or con-

struction equipment—it's always how much do you want to sell next year to get off our backs. And Korea is an example. Last year Korea came out with a surplus management plan. It's aptly named; it was a management plan. They wanted to manage the trade balance numbers so that they could defuse the political pressure in the United States. But we said that we're not interested in managing numbers; we're interested in gaining opportunity by Korea opening its market and letting the market determine whether the numbers are a \$10 billion deficit or a \$2 billion deficit. The Koreans really looked at us as if we were crazy. They don't understand that approach. So that's my first comment.

Number two, Steve also talked about the fact that we may need to take political heat or more political heat in the East Asian countries, that we should not be afraid of being characterized as bullies in these countries. If they want to characterize me or my staff or other U.S. Government officials as bullies, that's fine. But the political backlogs in these countries puts pressure on their officials as well, which makes it difficult for them too. At one level, it's a personal consideration. We've gone through a fair number of Directors General and Assistant Ministers in Korea. Negotiating with the United States is not necessarily the best way to move up the ladder in the Korean bureaucracy, because somebody will take a fall if an agreement is considered to be a concession to the United States. So it's very difficult for them to deal with that, when we push very hard and very overtly. Probably more important is the political system there, whether it's in Korea or Taiwan or Thailand. The political systems have limits—Thailand is a good example where their cabinet was disbanded after they passed a bill to provide us copyright protection. Yet we've got to continue to push because we have some important issues to deal with, and they have some outrageous barriers. But it will be difficult to continue to push adeptly enough that we don't run into situations where we keep losing Assistant Ministers or we keep losing cabinets. That is going to be difficult, particularly with democratization taking place.

The third point that Steve made—he referred to the Section 303 report—the National Trade Estimates, and in a context of looking to see whether the barriers with Korea, Taiwan, and others are significant. I think it is important to realize that the 303 report is really a reflection of the complaints that we get through our political system. It is not a rigorous analysis of what are the major impediments to increase U.S. exports. If one were to rank the reasons, for example, that we don't have a more balanced trading relationship with Taiwan or Korea or some of the ASEANs, one would not necessarily come up with a list that is in the 303 report. That's just a reflection of the way to a large extent our trade priorities are set. And to a certain extent, we are always going to have that kind of a system. We're not going to go all the way over to having somebody run a model and rank the barriers for us, and that we will go after them in order of priority. We're going to have to put some of that into the analysis or into our trade priority setting, but we are in a political system where people, firms, and industries have the right to bring forth their complaints, and the government will have to address those individual complaints.

I would just like to mention one other thing in terms of reasons that we may not be doing as well as people would like in these overseas markets. It's very important to realize the role that the United States plays in sucking in imports. We have very aggressive importers in our retail establishments and among the people who supply our retailers. If you look at the trade statistics of a place like Taiwan, it is mind-boggling. An enormous percentage of their exports to the United States are just written on order sheets that the K-mart buyers and J.C. Penny buyers and the Sears buyers, and so forth, take out with them to Asia. And as the costs of products rise because of the appreciation of the NT dollar or rising wages in Korea, these people shift to places like Thailand and to a less extent perhaps Indonesia, looking for alternative overseas sources who can fill this gap and who can make a particular object or specific kind of sweater, and meet their deadlines and meet their quality control. We don't face that same phenomenon on the other side. You don't find that with the Japanese. You don't find that with the Koreans. They have trading companies, buy they're really going after raw materials in large part, but they are not going after especially the consumer products which makes up so much of what at least the developing countries in Asia ship to us.

So those really are the major comments that I had on Steve's paper and on the discussion so far today.

Mr. AHEARN. Thank you, Peter. Steve, did you want to respond? Actually we're in overtime now, so why don't we accept one or two questions. Rich Cronin.

Mr. CRONIN. I have a basic question that maybe ties some of these thoughts together. It seems very reasonable to emphasize longer term access to markets and the export of high technology goods in order to sustain a balanced economy. And there are two ways to deal with the trade deficit. One is significantly cut back on imports and the other is to increase exports. Finally, we have been talking about the macroeconomic problem. I wonder if somehow we could tie these together a little better—that is, you have market opening measures on one hand and there's a good reason to do that, regardless of the numbers or the immediate impact on the trade deficit. But can you do the exports—can you in fact radically increase exports without dealing with the macroeconomic problem? And if you deal with the macroeconomic problem, doesn't that automatically mean a fairly drastic reduction in imports?

Mr. COHEN. It depends on how you deal with the macroeconomic problem. In theory, we could have the Federal Reserve quadruple interest rates tomorrow. That would produce a recession and that would do wonders for our exports on the upside and imports on the downside. You know there are good ways of doing it and bad ways of doing it. To me a good way of doing it is to gradually cool down the American economy with some more restrictive fiscal policy. Translation: small tax increases. So it can be done, I think, in an orderly manner, in terms of the tools available to economists.

The other thing I thought you were going to get at—maybe it was implied in your question—if we correct our macroeconomic policy and our exports go way up, what will that do to the world economy? It depends on what other countries do. The Japanese recently decided that they weren't going to have export-led growth so

they just went to some good old-fashioned fiscal policy stimulation. The Japanese economy is one of the fastest growing economies in the world today as a result. So to me, we can do it, and by expanding our exports, we do not necessarily hurt other countries.

Mr. CRONIN. Actually I was not implying that. The question is—do other countries have to distort their macroeconomics situation in order to pull in the exports from the United States?

Mr. COHEN. No, all they have to do is what the Japanese have done—decide to have faster growth and price stability at the same time. The Japanese are not exactly suffering from having stimulated their economy.

Mr. YERXA. I don't buy the premise that you can't do anything about exports unless you solve the macroeconomic problem. We've been having a real export boom, and unless you believe that Gramm-Rudman solved all our macroeconomic problems, we did it without solving them, partly because of exchange rates. But I think really exports are a function of producing enough goods at a high enough quality and respectable price that you can sell them on world markets. Countries have all kinds of differentiation in their export performance regardless of whether they're debtor countries or countries with large internal deficits, or what kinds of macroeconomic policies they pursue. I don't accept the premise that we can't do anything about the trade balance unless we solve our macroeconomic problem. We probably can't eliminate it, but we can improve it! We had a breakfast with Paul Volker this morning, and he was saying that we're probably not going to see much improvement in our current account balance, because even with this large surge in exports our current account is still deteriorating because of things other than the trade account. The merchandise trade deficit may be coming down but we're going to have a serious current account deficit for years.

Mr. CRONIN. Then you can see that the import side is tied to the macroeconomic situation.

Mr. YERXA. Yeah, it's tied to consumption, and it's tied in part to the fact that we're sucking in a lot of money to finance our deficit. I guess what I'm saying is that you can't sit around and wait for some miraculous fiscal solution before you start performing better as an exporting nation.

Mr. AHEARN. We have time for one last question—Mark?

Mr. BORTHWICK. I just want to ask for clarification because all three speakers have been coming down quite differently on the example of the semiconductors. Steve Cohen said the most interesting part of the agreement was the percentage allocation of the market which is precisely what didn't work. Rufus Yerxa said we don't need results anyway because politically there is a certain amount of symbolism involved and I quite agree when we're talking about trade bills. We don't want sudden dramatic results in the trade balances. On the other hand, if we're making agreements sector by sector—a debatable question tactically because of all the cross-cutting, unpredictable effects when you deal sector by sector—what kind of results do we want? Peter Allgeier says we don't want to negotiate specific percentages for market-opening and yet we did negotiate specific percentages in the semiconductor agreement. I

think that this perhaps indicates that certain inconsistency in our approach to market-opening measures.

Mr. COHEN. Yes, it's inconsistent. But I think it depends on what country you're talking about. My tax money would have been wasted if the U.S. Government had come back on the semiconductor talks with the Japanese with only the promise of yet another liberalization measure for semiconductors. It certainly wouldn't have worked. In discussing sectoral settlements I agree with you that there are inconsistencies. But I personally have the feeling that if the U.S. Government doesn't assure relatively free access to the Japanese market for our high-tech goods, which require high volume sales to achieve economies of scale and to move down the learning curve, our high-tech sector piece by piece will face the same fate as basic manufacturing.

I don't like these kind of deals particularly. I guess the question is what is the least worst situation, and to me, the way the semiconductor pact was negotiated is probably the lesser of the evils. Indeed, my answer is consistent, but it is a question of how do you deal with a very complex problem, and one that is in part particular to Japan, where classic market opening measures don't work. And I have to believe that those market opening measures are all important because of the economics of high-tech—such as high overhead costs—and the fact that, as I mentioned in the paper, if you give Japan a protected market, they will tend to have higher prices in the domestic economy and lower prices for exports. By giving them a protected home market, you also encourage Japanese companies to engage R&D expenditures that they might have done if they didn't have a protected market.

Mr. AHEARN. Last word—Peter or Rufus?

Mr. ALLGEIER. On the semiconductor agreement, as I said earlier, we don't go and seek numbers in the agreements, but sometimes you don't get everything you want in a negotiation. And if you see it as part of a process, at some point you agree on something as an interim measure. After all it was Ralph Waldo Emerson who said "A foolish consistency is the hobgoblin of small minds."

Mr. AHEARN. On behalf of the Congressional Research Service, the House Committee on Ways and Means, and the Woodrow Wilson International Center for Scholars, I would like to thank everybody for coming and ask all of you to thank our panelists for their very useful insights.

[Whereupon, at 5:35 p.m., a recess was taken.]

ASIA: CHALLENGES FOR THE UNITED STATES IN THE 1990'S

WEDNESDAY EVENING, JUNE 29, 1988

HOUSE OF REPRESENTATIVES, THE CONGRESSIONAL RE-
SEARCH SERVICE OF THE LIBRARY OF CONGRESS, THE
WOODROW WILSON INTERNATIONAL CENTER FOR SCHOL-
ARS, AND THE COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The workshop met at 7:30 p.m., in the Woodrow Wilson International Center for Scholars, the Smithsonian Institution.

MODERATOR: DAVID L. SHAMBAUGH, PROGRAM ASSOCIATE, ASIA PROGRAM, WOODROW WILSON INTERNATIONAL CENTER FOR SCHOLARS

SPEAKER: RICHARD HOLBROOKE, MANAGING DIRECTOR, SHEARSON-LEHMAN BROTHERS, N.Y.

Mr. SHAMBAUGH. I probably need not impress on all of you from Asia, or certainly those of you who work on Asia, that the future lies in the East. Indeed, way back early in the century, in 1902, Theodore Roosevelt's Secretary of State, John Hay, proclaimed, "Western history began with the Mediterranean era, passed through an Atlantic era, and is now moving to a Pacific era." That was back in 1902, so Hay was, indeed, very prophetic, if somewhat premature.

Well, today we are indeed, as many say, on the verge of the Pacific century; if we're not already in it. Sixty percent of the world population now live in Asia, and that percentage is increasing. The human and natural resources of the region are only part, I would say, of the success story to be found there. Economically, East Asia is clearly the most dynamic and economically growing region in the world. Many countries there have graduated to newly industrialized status, the NICs of the region with which we're all quite familiar, but they are indeed producing state-of-the-art technologies in the world. Politically, there's probably no other region in the world with a greater mix of political systems, ranging from North Korea to the dynamic democracies of the region. Strategically, there's no other region where the four major powers in the world interact, nor a region where the potential for the outbreak of hostilities involving these powers is greater.

For more than two centuries, the United States has had important interests and, indeed, a presence (for better or for worse) in East Asia. So as we move into the 1990s, and a new American administration next January in this city, the United States confronts

new circumstances and challenges. That is what we are here to contemplate tonight.

Our speaker tonight is Richard Holbrooke, who is currently a Managing Director of Shearson-Lehman Brothers in New York. Mr. Holbrooke is known to many of you, I'm sure, but let me tell you a little bit about him in case you aren't familiar with him and his long and distinguished career in government and the private sector. He entered the Foreign Service in 1962 and served in a number of key positions. He worked, for example, in the Agency for International Development in Vietnam before going on to be Special Assistant, in Vietnam, to the American ambassador Maxwell Taylor and Henry Cabot Lodge. In Washington, he has also served, both during the 1960s and then later in the 1970s, in the U.S. Government. First, in the 1960s, he served in the Office of the Assistant to the President for Vietnam, Assistant to the Under Secretary of State, and was a member of the U.S. delegation to the Paris Peace Talks, headed by Averill Harriman and Cyrus Vance. On that note, in fact, let me say that we're very pleased and honored to have Mrs. Averill Harriman with us tonight here at the head table.

Mr. Holbrooke also served as Peace Corps director in Morocco, and, from 1977 through 1981, was Assistant Secretary of State for East Asian and Pacific Affairs. He has also had quite a career in the private sector; including having been managing editor of *Foreign Policy* magazine, director of publications in the Carnegie Endowment for International Peace, contributing editor of *Newsweek International*, and a consultant to NBC. He's written widely on Asian and international affairs. In fact, this Monday you might have seen a very interesting piece in the *New York Times* by him about the Soviet party congress and its significance. He graduated from Brown University, and has also been a visiting fellow at the Woodrow Wilson School at Princeton University.

So, Dick, I'd like to welcome you to the "other" Woodrow Wilson Center, the Woodrow Wilson International Center for Scholars. So, ladies and gentlemen, I give you Richard Holbrooke, who will speak to you tonight about "Asia: The Political Challenge for the 1990s." [Applause.]

Mr. HOLBROOKE. Thank you very much, David. It's a pleasure to be back here again. I remember when the Woodrow Wilson Center was being created. There was some uncertainty about its future at the beginning of the 1970s. It's wonderful to see it today as an established and important center of discussion in this city and in the nation.

It's also a great pleasure for me to be asked to speak here again, and to see so many old friends and colleagues. I would particularly, if I might before I start, just like to acknowledge a couple of people here who have meant a lot to me over the years. First, Art Hummel, who was my predecessor in the East Asian Bureau as Assistant Secretary and who served with such distinction as our ambassador in Burma, Pakistan, and the People's Republic of China. He's been a special friend, and did a wonderful job for the United States throughout Asia. Secondly, there are three people in the audience tonight who had the dubious honor of working with me in the Bureau of East Asian Affairs as deputies: Tony Albrecht, in the

economic area, has a consultancy now, and will give you his business card on the way out; (laughter) Erland Heginbotham, who, along with his wife Ellie, have been friends of mine since we met in Saigon, 24 years ago, and was a wonderful deputy assistant and then became the first head of the Foreign Commercial Service: and, of course, Evelyn Colbert, the housemother to all of us who have worked in East Asian Affairs. I want one deal with Evelyn tonight. She has got to promise that when I say things that she knows are wrong, she will not tell everyone until it's over and we can talk in private. It's fun to argue with Evelyn and to work for her. Recently she and I collaborated on a project for the Trilateral Commission and it reminded me again how difficult it is to work for you, Evelyn. [Laughter.]

I also want to mention someone I didn't work for or worked for me but whom I've known for a long time, Bob Barnett. Bob was as important as anyone else in opening up my knowledge from Indochina to all of East Asia and the Pacific. He was a magnificent Deputy Assistant Secretary of State in East Asian Affairs. He pioneered such things as debt relief for countries. I think Indonesia might have gone under without him. He's been important to me and I want to acknowledge publicly what he has meant to me. I really don't think I would have gone on to my last job in the government if it weren't for the opportunities Bob gave me in the early 1970s.

I would like to try to talk about two things tonight. One is a general statement about the political challenges in East Asia, and then I'd like to conclude with a brief, highly informal and speculative comment about what we've seen in Moscow in the last week, and how it compares to what we've seen in China over the last decade. And then perhaps I might both join you in a speculation as to what its impact might be over time in Asia. Because I think one thing is clear: the events going on in Moscow now are of enormous historic importance. Something that important, involving one of the two superpowers of the world; a superpower with enormous Asian and Pacific interests, cannot, in the end, leave the Asian region unaffected. How it will effect events is something that we might start talking about tonight, although we certainly won't reach any definitive answer because we don't yet know clearly what's happening in Moscow. But before I turn to the Soviet Union, let me make a few brief comments about East Asia.

I don't need to tell anyone in this room about the economic miracle of Asia. Many of you have observed it, reported on it, participated in it, contributed to it, or tried to jump on its bandwagon as it pulls out of the station. We tend to take that for granted these days. We tend to accept the fact that Asian countries (not just Japan, but Korea, Taiwan, Singapore, Hong Kong, and increasingly Thailand and other parts of the region) are becoming important factors in the world economy. But for most of the last 20 years, we have tended to separate—as though they were unrelated—political stability and development on one hand and economic development on the other. I would submit to you that separation, that differentiation, is not viable in the long-term; and that in order for the economic miracle of East Asia to be sustained, political institutions must reach a level of maturity, stability, and internal, structural

solidarity which allows one to have confidence in the political future of the region. Otherwise, it is possible that by the end of the century, people may look back on the 1960s and 1970s and early 1980s not as the beginning of the new era in Asia, but as a brief, golden age of economic growth which was not undergirded by political development.

Very often we ignore these connections. I feel very strongly about them. I think that history will show that you cannot sustain economic growth without viable and sustainable political institutions. I want to stress at the outset that I am not arguing for replication, in countries in Asia, of America's political system or any other individual western country's political system. Each country must develop its own political institutions in its own way. The American system is one that I would especially not recommend to other countries; it works for us, but is a product of a unique historical experience. If Asians want to choose a different form: proportional representation, parliamentary, whatever, one house, two houses, it doesn't really matter. But what is essential is that governments derive their power and authority from the people in some legitimate form. Governments like Marcos' in the Philippines, Park Chung Hee's in Korea, Chiang Ching Kuo's in Taiwan, and other governments in the region could not be sustained into second and third generations of that kind of leadership.

Many of you in this room will say, and I will not debate the point at this time, that a period of authoritarianism was essential for economic development in these countries. That may or may not be true. We cannot test the opposite thesis in these specific cases. But even if that was true at one time in certain countries, that period has now come to an end. Now we all recognize the developments in most of East Asia have been positive in recent years. But I would stress that the report card is mixed, and the issue of political development still is in doubt in most of the region. Of course, Japan has proved that its governmental structure is viable and can weather almost any shock or challenge. That is equally true, obviously, of New Zealand and Australia at the other end of the Pacific basin. But after those three countries, the record is less clear cut.

First, the good news: in the last five years, Korea, Taiwan, the Philippines, and the People's Republic of China (in its own unique way within a communist structure) have all improved significantly their political structure. Indonesia and Thailand, I would say, have had no significant change at a fundamental level yet. But will change over time. Malaysia and Singapore have given particularly mixed picture, and I must say (speaking personally and with great admiration for the achievements of Premier Lee Kwan Yew over the last 25 years) I share the distress of many other people as to what is now going on in Singapore. I do not understand it, and again, with all respect to Lee, I do not find his explanations credible. We should not accept his explanations that westerners should not tell Asians how to behave when he himself had proudly chosen a western model for his country, and had told everyone for twenty-five years that Singapore embodies these values in an Asian context. But I expect that in time Singapore, with its enormously well-educated populace, will come out in good shape.

But leaving Malaysia and Singapore aside, I think that one has to say that the region, in general, has taken over the last five years the first tentative steps towards the kind of institutionalized political stability which, I submit to you, is essential for the region if it is to develop into a coequal center of power in the world with the Atlantic Community.

For over a decade now, all of us especially including myself, have made these speeches about "the Pacific Century" and the opportunities in the Pacific. I still hold that view, but I want to stress that it won't happen if we find ourselves in a cyclical pattern of experiments in which periods of liberalization alternate with authoritarian or repressive regimes. You cannot have that degree of uncertainty in the political process and sustain economic development. I believe that era of the military-based authoritarian regime, such as Korea, Indonesia and Thailand, are coming to an end. The degree to which each country in the region creates systems with orderly and predictable transitional structures (which, to me, is the key to a country's political system) will be critical.

China presents a uniquely complicated picture. While we all watch China with astonishment and admiration, and while I believe that what Deng Xiaoping has done since 1977 is the most extraordinary transformation that any country in the world has undergone in that period of time; I think that until we are three or five years past the end of Deng's era, we will not know to what extent he has succeeded in making his revolution in China sustainable and viable and irreversible.

I have excluded from this brief summary the other communist states of the region: Vietnam, Laos, Cambodia, and North Korea; because they really belong in a different category. But, I would note that even the Vietnamese, influenced by what's happened in China and, perhaps more importantly, what Gorbachev is doing in the Soviet Union, have begun to adapt themselves to a more open and slightly more liberal world. Some people even see signs of that in North Korea, but I think, in the final analysis, as long as Kim Il Sung is in power (and he is now the longest ruling leader in the world having gained power in 1945) it would be unrealistic to expect much change in North Korea. I would suspect that passing power from Kim Il Sung to his son, a dynastic succession without any historical precedent in any communist country in the world, will not be automatic. It's hard for me to believe that other leaders in North Korea would sit back and accept the son unless he possesses some internal strength beyond the legacy of his father.

Am I an optimist about East Asia? Of course I am! I wouldn't have spent most of the last 20 years of my life working in the area if I weren't. Do I believe in the region? I believe in it with all its excitement and potential just as much as most of the rest of you in this room. It certainly has the potential we've always said it has. But I stress this because we are seeing lots of new people discovering Asia for the first time, making their first trips to Tokyo, Beijing or Seoul, who come back and tell each other things about Asia which are palpable nonsense, based on no historical knowledge, no cultural/political understanding. They seem to think that Asia is just Europe with an Oriental face, and they don't understand that the returns are not in from Asia yet. The issue is not settled. So

forgive me for being slightly contrary and saying that those of you in this room who are Asian experts have to keep to a steady course in the face of a lot of bizarre overstatements, over optimistic statements by businessmen and Europeanists who've newly discovered Asia.

In this regard, I want to just go back to the question of what is happening in Moscow. I said earlier that no one knows what the effect will be, but there will be an effect. I don't think that when an event of the historic magnitude of the party conference that opened two days ago and what Gorbachev is attempting to achieve starts, it simply stops internally inside the country where it began. If Gorbachev's reforms take hold; if he succeeds in changing the party structure so the people in it see benefits to themselves in this reform; if he can get his reform structured, in place, and make them work; it will, of course, have a great effect on the rest of the world: western Europe, the United States, and East Asia.

One thing that interests me is the comparisons, similarities and differences, between what he is attempting to do and what Deng Xiaoping has done since 1977. First, some similarities in both the Soviet Union and China; we see the first real post-Stalinist regime in the Soviet Union, and the first post-Mao regime in the Soviet Union, and the first post-Mao regime in China. That is a clear similarity. Each man is going to try to deal with the historical legacy of a towering revolutionary figure, who also left a legacy and a system of repression. It has been said that nothing is as unpredictable in a communist country as its past. I think when you read in the newspapers today, that Trotsky is being reconsidered, it must be absolutely astonishing. I remember when Liu Shaoqi was rehabilitated posthumously in the People's Republic in 1980. It was a huge signal to the cadre throughout China that it was a new ball game. Similarly, when they talk about Trotsky and Stalin the way they are now, it sends a tremendous signal to everyone.

I think that, in both the Soviet Union and China, the leadership understood finally and belatedly that they were losing ground because of the technology revolution, because of the expansion of world trade. Not only to the west and Japan, which they might have accepted, but to third world countries; to countries like the Republic of Korea, to Singapore, to India, to Brazil. I think this was a major factor in Deng's reforms. I think there's a lot of evidence that the Soviet leadership sees the same problem.

Another interesting parallel: both Deng and Gorbachev seem to share an attempt to minimize their own cult of the personality. You don't see photographs of Deng Xiaoping publicly displayed in China. You don't see photographs of Gorbachev in the Soviet Union. This may seem routine, but it's quite unprecedented.

Both leaders are attempting to increase the role of the bureaucracy and the state structure at the expense of the party structure. That is a similarity, but there is a much more important difference in the area, and I think it is the central reason why Gorbachev has a tougher row to hoe than Deng. Deng was able to capitalize on the universal opposition to the legacy of the Gang of Four, whereas Gorbachev has to deal with an entrenched bureaucracy built up over 70 years, most members of whom currently in power, were

proteges of the Brezhnev era, and are threatened by perestroika. This makes Gorbachev's job much more difficult than Deng's.

Both countries seem to be trying to increase the importance of economic growth at the cost of ideological purity. This is a delicate problem because in the end, ideology is a central part of the glue that holds a communist state together. And, in the end, both countries may liberalize intellectually or economically, but they will not relinquish absolute party control of power. That is a key similarity.

But the differences are critical. I have already mentioned one the universal opposition to the Cultural Revolution made it easier for Deng than Gorbachev. The Soviet bureaucracy is more entrenched than the Chinese bureaucracy. And I think those are key differences.

There is another difference: personalities of the two men. Deng Xiaoping's personal background gave him roots in the party, the bureaucracy, and the Army. He's in his eighties. He's a Long March veteran. He is, literally, a living legend. Gorbachev is in his mid-50s, obviously enormously dynamic and impressive, but his roots do not include that kind of legendary past. He has opponents who are in his own generation. Deng's only opponents were men even older than him, some of whom even had to be carried in by nurses during the party congress.

Now, several people have observed that the biggest difference between the two countries is that Gorbachev is focusing first on political issues, while Deng focused first on economic issues. That is true, but slightly misleading. The reason Deng concentrated first on economic issues is that by December of 1978 he had completed the political takeover and reform of the country. Recall that for the first two years after Mao's death there was a real political struggle. It was in the streets, and it was at Democracy Wall. Deng very skillfully allowed Democracy Wall to create popular support for him until he had consolidated power in the Third Plenum of the Twelfth Party Congress in December of 1978, and then he just shut it down. You don't see political wall posters today because the political phase of the struggle was over early and he could move on to the economic phase.

Gorbachev had to start with the political phase, and that is now going on. I do want to stress one thing: not only in the Soviet Union (where it is the stuff of history that we're watching on television these days), but also in China (where people have begun to take Deng Xiaoping's revolution for granted), both countries. I would submit to you that the outcome is still in doubt. I believe that both men are more likely to succeed than fail, but it's not certain. I would hope they both do because I think it's in our interests. I think a more modern, outward-looking Soviet Union is good for stability in the Pacific as well as in the Atlantic area. I obviously believe the same about China. Sino-American relations in the last decade are testament to what can happen when a country's foreign policy no longer looks so hostile, and when interaction occurs at every level of society—intellectual, political, economic, business, trade, cultural, and so on.

So I conclude where I began, an optimist hoping that some of the excessive words of euphoria you hear sometimes when business men and other people who have just visited Asia for the first time

are correct. I think sometimes they're overblown. But I do believe that the region will be successful, and in it the United States must continue to play the role of the most important external force in the region—economically, strategically, and politically. Make no mistake about it: if the United States were to turn back from the region, if we were to become protectionist in a way that lapped over into the political arena and created a genuine nationalistic backlash (not a few demonstrations, but something really serious), if that firebreak was passed and we became viewed in a negative light in the region; if our political and strategic and economic base eroded; in the end, our own national security, as well as our economic status, would be severely imperiled. We are, and remain, a Pacific nation by virtue of geography, of history, of tradition, of self-interest. We must never forget that. Thank you.

[After a question and answer period, the workshop concluded at 10 p.m.]

